No. 01-463-CFX Title: United States, Petitioner
v.
Fior D'Italia, Inc.

Docketed: September 17, 2001 Court: United States Court of Appeals for the Ninth Circuit

Entry	Date	Proceedings and Orders
	Aug 1 2001	Application (01A100) to extend the time to file a petition for a writ of certiorari from August 16, 2001 to September 15, 2001, submitted to Justice O'Connor.
	Aug 3 2001	Application (01A100) granted by Justice O'Connor extending the time to file until September 15, 2001.
	Sep 14 2001	Petition for writ of certiorari filed. (Response due November 16, 2001)
	Sep 28 2001	Order extending time to file response to petition until November 16, 2001.
	Nov 16 2001	Brief of respondent Fior D'Italia, Inc. in opposition filed.
	Nov 21 2001	Reply brief of petitioner United States filed.
	Nov 28 2001	DISTRIBUTED for Conference of January 4, 2002
	Jan 7 2002	REDISTRIBUTED for Conference of January 11, 2002
	Jan 11 2002	Petition GRANTED. Petitioner's brief is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Monday, February 25, 2002. Respondent's brief is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Wednesday, March 27, 2002. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Monday, April 15, 2002. Rule 29.2 is suspended in this case. SET FOR ARGUMENT April 22, 2002. **********
	Feb 22 2002	Joint appendix filed.
	Feb 25 2002	Brief of petitioner United States filed.
	Feb 28 2002	Record filed.
	Mar 8 2002	CIRCULATED.
	Mar 26 2002	Brief amicus curiae of American Gaming Association filed.
	Mar 26 2002	Brief amicus curiae of National Restaurant Association filed.
	Mar 26 2002	Brief amicus curiae of Patricia R. Guancial filed.
	Mar 27 2002	Brief of respondent Fior D'Italia, Inc. filed.
	Apr 12 2002	Reply brief of petitioner United States filed.
	Apr 22 2002	ARGUED.

SUPREME COURT, U.S.
FILED

01-463 SEP 14 2001

No.

OFFICE OF THE CLERK

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the employer's share of the Federal Insurance Contributions Act (FICA) tax on employee tip income must be determined by accumulating the result of individual audits of individual employees or may instead be based on a reasonable estimate of the aggregate amount of tips received by all employees.

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In the Supreme Court of the United States

No.

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-33a) is reported at 242 F.3d 844. The opinion of the district court (App., *infra*, 34a-51a) is reported at 21 F. Supp. 2d 1097. The order of the district court denying reconsideration (App., *infra*, 52a-53a) is unreported.

JURISDICTION

The judgment of the court of appeals was filed on March 7, 2001. A petition for rehearing was denied on May 18, 2001 (App., *infra*, 54a). On August 3, 2001, Justice O'Connor extended the time within which to file

a petition for a writ of certiorari to September 15, 2001. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The relevant portions of Sections 446, 3111, 3121, 6053, and 6201 of the Internal Revenue Code, 26 U.S.C. 3111, 3121, 6053, and 6201, are set forth in the Appendix, *infra*, 55a-62a.

STATEMENT

1. Respondent operates a restaurant in San Francisco, California. Employees of the restaurant receive tips directly from customers. Those tips are sometimes pooled or shared with other employees. App., *infra*, 1a-2a, 4a-5a. Tips received by an employee who receives more than $20 in tips in any month are treated as "wages" for Federal Insurance Contributions Act (FICA) tax purposes. Both the employee and the employer are required to pay FICA taxes on the amount of such tips that are not in excess of the Social Security wage base. 26 U.S.C. 3111, 3121(a) and (q).[1]

Employees are required to make monthly reports to their employer of the tips they receive that constitute "wages" for FICA purposes. 26 U.S.C. 6053(a); 26 C.F.R. 31.6053-1(a)-(c). Restaurants with ten or more employees are required to make annual report. (Form 8027) to the Internal Revenue Service of the tips reported to them by their employees. See 26 U.S.C. 6053(c)(1), (4).

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[1] These limits on the amount of tips that constitute "wages" for FICA purposes are referred to as the "wages band" for these tax calculations. App., *infra*, 5a.

2. Respondent filed Forms 8027 that show that its employees reported tips of $247,181 for 1991 and $220,845 for 1992. These forms also showed, however, that the total amount of tips reported on customer credit card charge slips alone was $364,786 in 1991 and $338,161 in 1992. App., *infra*, 2a n.2. Respondent calculated its employer share of the FICA tax, however, only on the lesser tip amounts that its employees had reported receiving.

Because of the discrepancy in these reported tip amounts, the Internal Revenue Service conducted a compliance check of respondent's restaurant. The credit slip information reported by respondent revealed a 14.49% tip rate for 1991 and a 14.29% tip rate for 1992.[2] App., *infra*, 2a-3a. Multiplying these tip rates by respondent's gross receipts for those years—and then subtracting the total tips reported on respondent's Forms 8027—indicated that unreported tip income was approximately $156,545 for 1991 and $147,529 for 1992. *Id.* at 3a n.3. Applying the 7.65% FICA tax rate to these unreported tip amounts resulted in FICA tax deficiencies for the employer in the amount of $11,976 for 1991 and $11,286 for 1992. The Service sent a notice and demand for payment of these deficiencies to respondent pursuant to 26 U.S.C. 3121(q). In calculating the amount of respondent's FICA tax deficiencies, the Service did not conduct individual audits to determine the unreported tips received by each individual employee. App., *infra*, 3a.

3. Respondent paid a portion of the tax and filed this refund suit. Respondent did not dispute the reasonableness or accuracy of the Service's calculation of the

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[2] In 1991, 90% of respondent's sales were made on charge card slips. In 1992, 92% of sales were by charge. C.A. App. 55, 56.

amount of unreported tips. See App., *infra*, 32a-33a; C.A. App. 88. Instead, respondent asserted that the Service lacks authority to assess taxes on employers by using an aggregate estimate of tip income. Respondent claimed that the Service must instead base any assessment of FICA taxes on employers on individual audits of individual employees. The district court agreed with respondent. The court concluded that the Service is not permitted to make an assessment of employer FICA taxes on unreported tips until it first determines through individual audits the amount of unreported tips received by each individual employee. App., *infra*, 34a-51a.

4. a. The court of appeals affirmed in a 2-1 decision. App., *infra*, 1a-33a. The majority concluded that the assessment was invalid because "[i]t rests on an estimate in circumstances where Congress has not authorized the IRS to use estimation as an assessment method." *Id.* at 10a. While acknowledging that 26 U.S.C. 446 "has been interpreted as giving the IRS authority to make an assessment based on an estimate," the majority concluded that "the IRS cannot rely on section 446 as authority for the assessment here because the section does not apply to the collection of FICA taxes." App., *infra*, 6a, 10a.

The majority also stated that the Service's method of estimation "has some serious flaws." App., *infra*, 8a. The court stated that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" (*ibid.*) because it is based on tips paid by customers using credit cards and "experience shows that charged tips generally exceed cash tips." *Id.* at 4a. The court also emphasized that "the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to

employees by the restaurant" and does not "make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." *Id.* at 8a-9a. See note 1, *supra*.

The majority concluded that the Service may not employ an aggregate method for estimating the employer's FICA tax directly and must instead first "audit[] the employees' records or otherwise determin[e] the amount each employee earned in tips." App., *infra*, 13a. The court held that "there is no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned." *Ibid.*

b. Judge McKeown disagreed with the reasoning and conclusion of the majority. App., *infra*, 18a-33a. She explained that, even if "the statutes do not directly address whether the IRS has the authority to make aggregate assessments with respect to unreported tips, * * * they are certainly broad enough to permit the IRS to do so." *Id.* at 25a. She noted, moreover, that the decision in this case squarely conflicts with the decisions of several other circuits that have upheld the authority of the Internal Revenue Service to make assessments of employer FICA taxes based on aggregate calculations of unreported tip income. *Id.* at 19a-23a (citing *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d 990 (7th Cir. 2000); *Bubble Room, Inc.* v. *United States*, 159 F.3d 553 (Fed. Cir. 1998); *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d 1526 (11th Cir. 1997)). Judge McKeown emphasized that "[e]very circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority." App., *infra*, 22a. She concluded that these other circuits correctly rejected the assertion raised by respondent that individual

audits of individual employees must be conducted before FICA taxes may be assessed against the employer. *Id.* at 23a-30a. In reaching that conclusion, she expressed "particular concern" with the majority's determination to "place[] the Ninth Circuit directly at odds with [its] sister circuits" and emphasized that "[u]niformity among Circuits is especially important . . . to ensure equal and certain administration of the tax system." *Id.* at 19a (quoting *Hill* v. *Commissioner*, 204 F.3d 1214, 1217-1218 (9th Cir. 2000)).

c. The petition for rehearing en banc filed by the United States was denied by the court of appeals. App., *infra*, 54a.

REASONS FOR GRANTING THE PETITION

This case presents a frequently recurring question of significant importance on which the courts of appeals are in sharp conflict. As the dissenting judge correctly noted, the decision of the court of appeals "creates a circuit split on a tax issue of national importance." App., *infra*, 18a. The correct resolution of the question presented in this case affects the taxes owed by each of the tens of thousands of businesses whose employees regularly receive tip income. Resolution of this conflict by this Court is needed to preserve uniform application of the FICA tax throughout the Nation and to avoid disparate treatment of similarly situated taxpayers based solely upon the happenstance of their geographical location.

1. a. The FICA tax has an employee portion and an employer portion. Each employee is required to pay a specified percentage of the "wages" he receives. 26 U.S.C. 3101. This employee portion of the tax is to be withheld from the employee's "wages" and remitted by the employer to the Treasury. 26 U.S.C. 3102(a).

Congress has also imposed a separate FICA tax on every employer. 26 U.S.C. 3111. The employer portion of the FICA tax is a specified percentage of the "wages * * * paid by him with respect to employment." 26 U.S.C. 3111(a). The term "wages" is defined for this purpose to mean "all remuneration for employment." 26 U.S.C. 3121(a). Tips received by an employee are included within this definition of "wages" unless the amount is less than $20 in any calendar month. 26 U.S.C. 3121(a)(12)(B); 26 C.F.R. 31.3121(a)(12)-1.

Section 3121(q) of the Code specifies that the tips received by an employee are "deemed to have been paid by the employer" for purposes of the FICA tax. 26 U.S.C. 3121(q). The statute thereby requires employers to pay the employer share of FICA taxes on all tips received by employees, up to the Social Security wage base. 26 U.S.C. 3121(q); see 26 U.S.C. 3121(a)(1) (limiting "wages" to amount of Social Security wage base).[3] As the Eleventh Circuit explained in *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529, Section 3121(q) provides "that an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips" and thereby indicates "that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined." The history of Section 3121(q) comports with this understanding, for the Conference Report on the bill that enacted this provision specifies that the employer portion of the FICA tax must be paid "on the total amount of wages and cash tips * * * ." H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 802 (1987).

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[3] In 1991 and 1992 (the years at issue in this case), the Social Security wage base was $53,400 and $55,500, respectively.

b. Employees are required to report their tips in monthly statements to the employer. 26 U.S.C. 6053(a). Under 26 U.S.C. 3102(c)(1), the employer's duty to collect the *employee* share of FICA taxes applies only for the tips included in the employee's written statements under Section 6053(a). See 26 C.F.R. 31.3102-3(a)(2).[4] In 26 U.S.C. 3121(q), however, Congress provided a different rule for the *employer* portion of the FICA tax, specifying that, "where no statement including such tips was * * * furnished [by the employee]," the employer's obligation to pay its portion of the tax is deemed to have been incurred "on the date on which notice and demand for such taxes is made to the employer by the Secretary." Congress has thus specified that the employer portion of the FICA tax may be assessed even when employees do not accurately report their tips.[5]

In this case, respondent paid the employer portion of the FICA tax only on the tips that were reported by the employees on their statements under Section 6053(a). Sections 3111 and 3121(q) impose the employer portion of the FICA tax on *all* tips received by the employees, however, whether those tips have been reported or not. Pursuant to the authority conferred on the Treasury to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title" (26 U.S.C. 6201), the IRS determined the aggregate amount of tips received by respondent's employees

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[4] The IRS therefore has not claimed that respondent has underwithheld the employee share of FICA taxes.

[5] The restriction under 26 U.S.C. 3102(c) concerning withholding of the Section 3101 employee tax does not apply to payment of the employer tax. See note 4, *supra*, and accompanying text.

and assessed the resulting taxes under 26 U.S.C. 3111. See page 3, *supra*.

2. a. The court of appeals erred in holding that this "aggregate" method of assessing the employer's portion of the FICA tax is impermissible. The court majority did not dispute that the employer portion of the tax may be assessed without making equivalent assessments of individual employees. The court reasoned, however, that the employer portion of the tax could lawfully be determined only by adding up individual employee tips and not by estimating the aggregate amount of tips received by all employees. App., *infra*, 13a.

The court did not point to any language in the Internal Revenue Code as support for its conclusion, and there is none. The employer portion of the FICA tax imposed by Section 3111 is a separate and distinct obligation from the employee tax in Section 3101. Nothing conditions the determination of one on any determination of the other. Section 3111(a) imposes the tax on an employer in an amount equal to a specified percentage of "the wages * * * paid by him with respect to employment." 26 U.S.C. 3111(a). Section 3121(q) defines wages to include tips but, for the reasons described above, refutes the suggestion that only the tips reported by the employee are to be treated as "wages" in determining the employer portion of the tax. See pages 7-8, *supra*. In short, nothing in the relevant statutes that impose the employer portion of the FICA tax requires the IRS to make the individual determinations required by the court of appeals.

Nor is the court below correct in concluding (App., *infra*, 11a) that the IRS lacks authority to base FICA tax assessments on reasonable aggregate estimates rather than on individual, factual audits. The court

acknowledged that 26 U.S.C. 446(b) has long "been interpreted as giving the IRS authority to make an assessment based on an estimate." App., *infra*, 6a (citing *McQuatters* v. *Commissioner*, 32 T.C.M. (CCH) 1122 (1973)). That statute provides that, "[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." 26 U.S.C. 446(b).

In *McQuatters*, the Tax Court concluded that this statute authorizes the agency to use aggregate estimates to determine the amount of an employee's unreported tip income for income tax purposes. See also *Mendelson* v. *Commissioner*, 305 F.2d 519 (7th Cir.), cert. denied, 371 U.S. 877 (1962). Even without referring to Section 446(b), other courts have approved of the use of estimates in determining the amount of unreported income simply as a reasonable method of determining a disputed factual issue. See, *e.g.*, *Erickson* v. *Commissioner*, 937 F.2d 1548 (10th Cir. 1991); *Delaney* v. *Commissioner*, 743 F.2d 670 (9th Cir. 1984); *Gerardo* v. *Commissioner*, 552 F.2d 549 (3d Cir. 1977); *Mitchell* v. *Commissioner*, 416 F.2d 101 (7th Cir. 1969), cert. denied, 396 U.S. 1060 (1970). See also *United States* v. *Janis*, 428 U.S. 433, 437, 441 (1976) (describing the calculation of a wagering excise tax assessment based on a reasonable estimate of wagers made); *Carson* v. *United States*, 560 F.2d 693, 698-700 (5th Cir. 1977) (wagering excise tax assessment properly based on a reasonable estimate of total wagers accepted by a bookmaker); *DiMauro* v. *United States*, 706 F.2d 882 (8th Cir. 1983) (same). The conclusion of the majority in this case that the IRS lacks authority to make aggregate estimates of items of income in assessing taxes

thus conflicts with the long-established contrary holdings of all other courts that have addressed this issue.

The majority nonetheless concluded that Section 446 suggests an intention to limit aggregate estimates of items of income based on the proposition that "Congress obviously knew how to give the IRS the authority to use estimation in lieu of actual calculations, and just as clearly thought it necessary to say so explicitly when it wished to confer that power." App., *infra*, 10a. That reasoning is erroneous, however, for Section 446(b) plainly does not "explicitly" say anything about using estimates. It merely authorizes the Treasury to require methods of accounting that "clearly reflect income." 26 U.S.C. 446(b).

It thus cannot realistically be asserted that the statutory text reveals an intention of Congress to preclude the use of methods of estimation in tax calculations in circumstances other than those expressly described in the statute. See *Palmer* v. *IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997) ("Congress specified no particular methods or evidentiary burdens on the Commissioner when choosing a method for reconstructing a taxpayer's income under Section 446. The Commissioner, therefore, has wide discretion in choosing an income-reconstruction method."). As the Eleventh Circuit correctly concluded in *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529, "[g]iven the structure of the Internal Revenue Code, we are unconvinced that Congress's silence can be construed to mean that an employer cannot be assessed its share of FICA taxes based on employees' unreported tips in the aggregate without determining the underreporting by the individual employees."

In her dissent in this case, Judge McKeown properly identified the source of the agency's general authority to use estimates in making FICA tax assessments. Section 6201 broadly authorizes the Secretary to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title." 26 U.S.C. 6201. In making tax assessments under the Internal Revenue Code (including FICA tax assessments), Congress has thus left it "up to the IRS to choose the method [to determine the amount of taxes], so long as reasonable." App., *infra*, 26a. As the Federal Circuit concluded in rejecting the same contentions endorsed by the court below in this case, "[26 U.S.C.] 6201 implicitly authorizes the IRS to use an indirect formula" because "the IRS would have to use an indirect formula to estimate the amount of FICA tax owed by an employer when there is no other way to 'determine and assess' the wages deemed to have been paid by the employer." *Bubble Room, Inc.* v. *United States*, 159 F.3d 553, 565 (Fed. Cir. 1998). While the panel in the present case acknowledged that its decision conflicts with the decision of the Federal Circuit in *Bubble Room* (App., *infra*, 12a, 13a n.9, 15a n.12), the panel failed to address the reasoning of that decision and gave no consideration to the relevance of Section 6201 to this case.

b. The fact that reasonable, aggregate estimates may properly be employed in determining the employer's FICA tax liability is especially apparent in view of the fact that Section 3121(q) authorizes the IRS to issue a demand for payment of such taxes even when the statements given by employees to the employer are "inaccurate or incomplete." 26 U.S.C. 3121(q). In such circumstances—where accurate and complete records showing the amount of tips do not exist—the IRS has no plausible alternative but to rely on an indirect

method to estimate the tips. In resolving the factual question of the amount of tips received in this context, other courts of appeals have unanimously concluded that "the IRS may base assessments on indirect formulas in circumstances where it is clear that the taxpayer has understated the amount of wages received and it is impossible or impractical to determine the exact amount of wages actually received." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 566.

Moreover, the majority's conclusion that an estimate of the employer's FICA tax liability is impermissible, and that what is required is an "employee-by-employee determination of the taxable tips each has earned" (App., *infra*, 13a), suffers from an obvious internal contradiction. If the IRS were to audit each employee to determine the amount of tips each employee earned, those individual determinations would themselves necessarily be based on estimates. It is obvious that any cash tips that are not reported on the credit charge slips retained by the employer cannot be traced and determined with precision. A method of estimation based on the average tip rate and the gross sales of the restaurant is far more likely to achieve factual accuracy than the individual audits suggested by the court of appeals. In any event, the court's suggestion that adding up the results of individual audits would make the estimation of tip income unnecessary is clearly incorrect—the sum of individual audits would simply be the sum of individual estimates of tip income.

c. For the reasons already described, the majority erred in suggesting (App., *infra*, 10a) that the IRS must obtain some more express authorization from Congress before making aggregate assessments of the employer portion of the FICA tax on tips. In making that suggestion, moreover, the majority failed to consider the

most recent legislation enacted by Congress to address the FICA tax on tip income. In 1998, in response to restaurant industry complaints about the IRS practice of determining an employer's liability for FICA taxes based on aggregate tip income (and the decision of the Eleventh Circuit in *Morrison Restaurants* approving of that practice), Congress enacted a statute that provides that IRS employees "may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering a Tip Reporting Alternative Commitment [TRAC] Agreement." Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 685. A restaurant that signs a TRAC agreement with the IRS agrees to educate its employees about tax reporting, establish procedures to ensure accurate tip reporting, and fulfill various federal tax requirements. In return, the IRS agrees to base the restaurant's FICA tax liability solely on reported tips and any unreported tips discovered during an IRS audit of an employee. See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 274-275 (1998); S. Rep. No. 174, 105th Cong., 2d Sess. 75 (1998); H.R. Rep. No. 364, 105th Cong., 1st Sess. Pt. 1, at 199 (1998).

As the dissent in this case correctly observed, this statute reflects the understanding of Congress that, in the absence of such a TRAC agreement, the IRS has full authority to make aggregate assessments against employers without making determinations with respect to individual employees. App., *infra*, 28a. As the dissent concluded, when Congress enacted the 1998 law, it necessarily "*acknowledged the IRS's power to make aggregate calculations* of employer tax obligations, before or without making determinations with respect to individual employees." *Ibid.*

d. The majority also erred in concluding that the aggregate estimate of tips made by the IRS in this case has "some serious flaws." App., *infra*, 8a. The dissent aptly observed that the majority "confuses the IRS's authority to use the aggregate method with the accuracy of that method." *Id.* at 32a. "[W]hether there are flaws in the indirect formula used to estimate the FICA tax is a separate matter from whether the IRS has the authority to assess an employer-only FICA tax based on an aggregate estimate of unreported tip income." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 568. Accord, *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996. See also *United States* v. *Schroeder*, 900 F.2d 1144, 1149-1150 (7th Cir. 1990) (proof that amount of assessment is incorrect does not invalidate entire assessment), *Burns* v. *United States*, 974 F.2d 1064, 1066 (9th Cir. 1992).

Moreover, there is no evidence to support the majority's conclusion that "flaws" exist in the agency's aggregate estimate of tips.[6] The majority first suggested that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" because "experience shows that charged tips generally exceed cash tips." App., *infra*, 4a, 8a. There is simply no evidence in the record of this case to support the court's assertion that "experience" reveals that the charge tip rate at respondent's restaurant exceeded the cash tip rate at that restaurant.

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[6] The suggestion of the court of appeals that there are "flaws" in the aggregate estimate of tips is particularly inappropriate in this case since respondent has not itself challenged the reasonableness or accuracy of the agency's estimate. See C.A. App. 88. Respondent relied solely on its assertion that the IRS lacked authority to make an aggregate estimate in determining the employer portion of the FICA tax on tips. See App., *infra*, 33a.

Similarly, the majority erred in stating that, "[a]s to credit card tips, the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to employees by the restaurant." App., *infra*, 8a-9a. There is again no evidence in the record—or even any assertion by the taxpayer—that this procedure was in effect at respondent's restaurant. See also *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567-568. In fact, California statutes expressly prohibit the theoretical practice that the court of appeals assumed to have been applied in this case. See Cal. Labor Code § 351 (West 2001) ("An employer that permits patrons to pay gratuities by credit card shall pay the employees the full amount of the gratuity that the patron indicated on the credit card slip, without any deductions for any credit card payment processing fees or costs that may be charged to the employer by the credit card company."). The asserted "flaw" identified by the court of appeals was thus solely of its own conjecture, not of the agency's method of estimation.

Finally, the court stated that "the estimate [does not] make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." App., *infra*, 9a; see note 1, *supra*. But there again is no evidence in this case that any of respondent's employees earned less than $20 in tips in any month; nor is there any evidence that any of its employees received tips plus salary in excess of the Social Security wage base. In the absence of evidence that some of the unreported tips fell outside the wages band, the court's suggestion that the failure to account for the such amounts is a "flaw" in the tip estimate is mere speculation. In any event, the theoretical possibility that some minor portion of the tips received might fall outside the wages

band would not invalidate the entire assessment. *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567 (failure to take the "wages band" into account does not "make the assessment unlawful" but, rather, "merely suggests that the amount of FICA tax assessed against [the employer] may have been incorrect by some margin and that it may be entitled to a refund of some portion of the FICA tax assessed against it"); *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996. It is the employer's obligation to establish the amount by which the assessment is incorrect, and the employer declined to mount such a challenge in this case.

The majority expressed concern that an aggregate estimate of unreported tip income "puts an impossible burden on [the taxpayer], making the already heavy presumption that attaches to an IRS assessment virtually conclusive." App., *infra*, 8a. That concern, however, is belied by the proceedings in the *Bubble Room* case. The employer in that case pointed to several purported defects in the methodology employed by the IRS in calculating the assessment. The court concluded that there were genuine issues of material fact that made summary judgment on the amount of the employer's liability inappropriate. 159 F.3d at 567. As correctly observed by the dissent here, "the aggregate method is predicated on a reasonable estimate and that may be challenged by the taxpayer." App., *infra*, 33a. In this case, however, respondent chose not to raise any argument about the correct amount of its liability in the proceedings below. As the dissent emphasized, "the issue of accuracy is not before us, because [respondent] did not challenge the accuracy of the calculation—it challenged only the IRS's authority to assess the taxes under the aggregate method." *Ibid.*

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ployer's share of FICA taxes *without determining the individual employees' unreported tips.*" As the dissenting judge correctly concluded, the panel decision thus "creates a circuit split on a tax issue of national importance" and "places the Ninth Circuit directly at odds with" the decisions of "[t]hree other circuits." App., *infra*, 18a-19a.

4. The question presented in this case is one "of national importance" because it affects the tens of thousands of businesses whose employees receive tip income. The National Restaurant Association stated in an amicus brief filed in the court of appeals that this issue has significant "impact on the industry nationwide," for it directly affects the 170,000 restaurant units operated by its members (Amicus Br. 1, 6). Moreover, as the panel majority recognized, "the problem of collecting taxes on employee tips" involves a "substantial amount of revenue." App., *infra*, 17a.

The correct reporting of tip income is a matter of recurring and substantial importance in the enforcement of the FICA tax. The Internal Revenue Service has been charged with the responsibility of ensuring full compliance with the FICA tax. The reasonable estimation of tip income—in combination with the related TRAC program described at page 14, *supra*—has been recognized by Congress as an indispensable component of that enforcement program. A study mandated by Congress in 1984 revealed that tipped employees generally reported only slightly more than one-half of their tips. Research Division, Internal Revenue Service, Pub. 1530, *Tip Income Study: A Study of Tipping Practices in the Food Service Industry for 1984* (1990). The enforcement programs pursued by the IRS in response to this 1984 study have substantially increased tip reporting in the restaurant industry. The

IRS advises us that the amount of reported tips from that industry increased from $8.52 billion in 1994, to $9.45 billion in 1995, to $10.19 billion in 1996, to $11.14 billion in 1997, to $12.17 billion in 1998, and to $14.31 billion in 1999. Similarly, in other industries in which the agency's tip enforcement programs have been implemented (such as the Nevada gaming industry), tip reporting has increased significantly even without any corresponding increase in associated industry revenues.

But, as the dissent noted, the majority's approach in this case "invites employers and employees alike to evade their statutory tax obligations." App., *infra*, 31a (citing *Bubble Room, Inc.* v. *United States*, 159 F.3d at 597; *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530). Especially in view of the "substantial amount of revenue" affected by this decision (App., *infra*, 17a), review by this Court is warranted to resolve the sharp conflict that now exists among the circuits on the important, recurring question presented in this case.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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SEPTEMBER 2001

APPENDIX A

UNITED STATES COURT OF APPEALS
NINTH CIRCUIT

No. 99-16021

FIOR D'ITALIA, INC., PLAINTIFF-COUNTER-DEFENDANT-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-COUNTER-CLAIMANT-APPELLANT

[Argued and Submitted Mar. 15, 2000]
[Filed Mar. 7, 2001]

OPINION

KOZINSKI, Circuit Judge.

In a dispute involving a restaurant's share of Social Security taxes on its employees' tip income, we explore the outer bounds of the IRS's power to make tax assessments.

I

Like most restaurants, Fior D'Italia employs waiters, table bussers, bartenders and others whose earnings come in part from tips left by customers. Although these tips are paid by customers directly to employees, federal law deems them to have been paid by the

employer for purposes of FICA taxes. *See* I.R.C. §§ 3101, 3111, 3121(a) & (q). This puts employers in an awkward position: They are "deemed," for purposes of tax law, to have paid large sums of money that they have never touched and whose exact amounts they have no way of ascertaining. *See* I.R.C. § 3121(q).[1] Yet employers need to know how much tip income employees receive in order to calculate their own FICA taxes and withhold appropriate amounts from the wage portion of the employees' compensation, pursuant to I.R.C. § 3102.

To make this information known to employers, tipped employees must submit monthly statements (usually on Form 4070) reporting all tip earnings that qualify as wages under the statute. *See* I.R.C. § 6053(a); Treas. Reg. § 31.6053-1(a). Employers, in turn, must report to the government (on Form 8027) their gross sales, charged tips and the tip amounts reported by employees. *See* I.R.C. § 6053(c)(1).

The dispute before us arose because in 1991 and 1992, Fior D'Italia reported aggregate tips that were significantly less than the tips that appeared on its credit card charge slips.[2] The Internal Revenue Service assessed Fior for additional FICA taxes on what it deemed was unreported tip income for those years. To determine

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[1] Some restaurants (not Fior) require all employees to pool cash tips for subsequent redistribution, in which case they do know, at least insofar as employees do not pocket some of the tips before pooling the rest. *See 330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 993 (7th Cir. 2000).

[2] For 1991, disclosed total charged tips were $364,786, while total tips reported by employees were $247,181. For 1992, the numbers were $338,161 charged and $220,845 reported.

what Fior owed, the IRS used a simple calculation: For each year, it divided total tips charged on credit cards by total credit card receipts, yielding an average tip rate of 14.49% and 14.29% for 1991 and 1992, respectively. It then applied this "tip rate" to the restaurant's gross receipts to get a presumed tip total for the year. The IRS assessed Fior additional FICA taxes based on the difference between its presumed total and the amount of tips Fior's employees had reported.[3] The IRS did not readjust the FICA or income tax liability of the various employees who may have understated tip income on their 4070 forms.

Fior challenged the assessment method in district court, arguing that it exceeded the IRS's authority. The district court agreed, *Fior D'Italia, Inc. v. United States*, 21 F. Supp. 2d 1097 (N.D. Cal. 1998), and the government appeals.

II

Because we must decide whether the IRS's assessment is valid, we begin by examining what exactly the IRS is assessing. Section 3111 imposes on every employer a tax equal to a percentage of "the wages . . . paid by him with respect to employment." I.R.C. § 3111(a). These wages are defined to include "tips received by an employee in the course of his employment." I.R.C. § 3121(q). But Congress did not treat all tips as taxable wages for this purpose. In section 3121(a)(1), it excluded all remuneration from the employer (salary plus tips) that exceeds the Social

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[3] The IRS concluded that unreported wages totaled $156,545 in 1991 and $147,529 in 1992.

Security wage base for that year.[4] In section 3121(a)(12)(B), it excluded all cash tips received by an employee if that amount was less than $20 in a given month. These latter two provisions are often described as defining the "wages band" outside of which tip income is not taxed. *See Bubble Room, Inc. v. United States*, 159 F.3d 553, 555-56 (Fed. Cir. 1998) (*Bubble Room II*). For the IRS's aggregate assessment method to precisely equal the tips on which the employer's FICA tax is calculated, the cash tipping rate must be exactly the same as the tipping rate on charge slips, and total tips received must be distributed among employees so that none falls outside the wages band.

Neither condition will hold true in most cases. First, experience shows that charged tips generally exceed cash tips. *See Yukimura v. Commissioner*, 43 T.C.M. (CCH) 467, 470, 1982 WL 10891 (1982). One can think of many reasons why this would be so. Spending credit is easier than spending cash, because actual payment is deferred. Also, people dining on expense accounts generally pay with credit cards, and spending someone else's credit is even easier than spending one's own. Then there is the convenience of being able to write a tip in precisely the amount one deems appropriate. People paying in cash, however generous they may feel, are limited by the amount actually in their wallets and the need to keep some cash until their next visit to Gringott's. Applying the charged tip rate to cash receipts will thus tend to overestimate the cash tips actually paid. And charged tips paid to employees may be less than appears on the credit card receipts, because some employers pass on the three percent fee

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[4] This base was $53,400 in 1991 and $55,500 in 1992.

assessed by the credit card companies. *See Bubble Room, Inc. v. United States*, 36 Fed. Cl. 659, 663 (1996) (*Bubble Room I*), *rev'd*, *Bubble Room II*, 159 F.3d 553.

The assumption that all tip income falls within the wages band is even more problematic because Fior's employees, like those of many other restaurants, engage in tip sharing. Waiters receive tips from the customers and then share them with table bussers, bartenders and other employees. Much like tips left by the customer, the exact amount shared with others depends on the waiter's generosity and his evaluation of how much other employees contributed to customer satisfaction. Looking only at the aggregate tips collected, we cannot tell how many table bussers made less than $20 in indirect tips per month for some or all of the periods in question.[5] Nor is there any way of knowing how many waiters and hosts received salaries plus tips exceeding the Social Security wage base-something we cannot rule out for an upscale restaurant like Fior D'Italia.

While an employer may be aware that reported tips are less than actual charged tips, it cannot be sure that employees are understating tips in their 4070 forms. Some or all of the discrepancy could be explained by the fact that employees are not required to report tips falling outside the wages band. Even if the employer suspects that some employees are understating their tip income, it has no way of knowing who is underreporting or by how much. Restaurants cannot force waiters to divulge how much they have actually

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[5] While $20 in tips per month is not very much, employees who start employment, leave employment, or take vacation or sick leave within a particular month may well earn less than that.

received in tips, and how those amounts were shared with other employees. Nor are employees likely to volunteer such information, because they would be admitting that they committed tax fraud by understating their tip income on the IRS form they submitted to the employer.

The IRS is unimpressed. It believes itself empowered to use any rational method for assessing the tax; the difficulties the employer raises can be considered in determining the precise amount of tax actually owed. If the assessment is valid, the burden shifts to the taxpayer to prove the amount (if any) by which the assessment overstates the tax owed. The question remains whether the assessment is valid.

III

The IRS's authority to make assessments is a very powerful tool. By making a valid assessment, the IRS shifts to the taxpayer the burden of proving that it does *not* owe the amount of tax the IRS has assessed it. If the taxpayer cannot persuade a trier of fact that the amount assessed is incorrect, the IRS wins and the taxpayer is required to pay that amount. *See Palmer v. IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997). So long as the assessment is supported by a "minimal factual foundation," the IRS need not present any additional evidence; the risk of uncertainty falls on the taxpayer. *Id.*

In the income tax context, an assessment becomes even more powerful when coupled with the IRS's authority pursuant to I.R.C. § 446 to redefine the manner in which the taxpayer computes income. Section 446 has been interpreted as giving the IRS authority to make an assessment based on an estimate rather

than a computation. *See McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122, 1125, 1973 WL 2419 (1973). This means that, in making the assessment, the IRS need not rely on the actual records kept by the taxpayer. Where such records are inadequate, the IRS may make an educated guess as to how much tax is owed, and then put the burden on the taxpayer to prove it wrong.

McQuatters also involved tip income but, unlike our case, it involved the income taxes of the employees who had actually received the income. *See also Mendelson v. Commissioner*, 305 F.2d 519 (7th Cir. 1962). The tipped employees had failed to maintain adequate records of the tips they had received, and the courts held that the IRS was authorized to use an estimate in making its assessment. Because the employees should have maintained records of their income but failed to do so, it was deemed entirely appropriate to put the burden on them to prove that the IRS's estimate overstated their taxable income. *See id.* at 523 ("Obviously, where a taxpayer keeps no records disclosing his income, no method can be devised which will produce an exact result. The law does not require that much."); *McQuatters*, 32 T.C.M. (CCH) at 1125 ("In the absence of adequate record keeping by petitioners, [the IRS] was justified in reconstructing their tip income by an indirect method. . . .").

The taxpayer in our case is in a very different position from the taxpayers in *McQuatters* and *Mendelson*. While each employee knows how much he receives in tips, the restaurant does not. Employees, moreover, have an obligation to maintain records of their tip income and to accurately report such income to their employer on a monthly basis. The restaurant has no

obligation to maintain records of tip income, except to the extent its employees report on Form 4070. Unlike the taxpayers in *McQuatters* and *Mendelson*, then, the taxpayer in our case did not fail to satisfy a legal duty imposed on it by the Internal Revenue Code, and thus did not give the IRS just cause for resorting to an estimate in constructing its assessment.

Also, unlike the taxpayers in *McQuatters* and *Mendelson*, Fior is not in an inherently better position than the IRS to determine what its employees actually earned in tips. Quite the contrary: Fior lacks the IRS's power to audit its employees and has no other means of forcing its employees to divulge how much tip income they earned during a given year.[6] Forcing the restaurant to prove that the estimate is wrong puts an impossible burden on it, making the already heavy presumption that attaches to an IRS assessment virtually conclusive.

We find this particularly troubling because the IRS's estimate has some serious flaws. As discussed above, the IRS's method for estimating cash tips likely overstates the amount of such tips received. *See* pp. 846-47 *supra*. As to credit card tips, the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to

[6] The government suggests that the employer *could* know exactly how much each employee makes in tips by adopting a tip-pooling arrangement. *See* note 1 *supra*. But adopting such an arrangement would alter the way a restaurant does business by undermining the incentive structures created by discretionary tip-sharing. It would be akin to saying that a restaurant must charge a fixed service charge in lieu of tips. Obviously, a restaurant cannot be required to change its business practices in order to avoid paying taxes it doesn't owe.

employees by the restaurant. Nor does the estimate make allowance for the statutory wages bands which limit the restaurant's FICA tax liability.

We can't ignore these inaccuracies on the theory that they will cancel each other out in the long run; they all overstate the base on which the FICA tax is calculated and thus will combine to overstate the amount the taxpayer owes. As Judge Plager noted in his dissent in *Bubble Room II*, "[t]hough it may be that the excess taxes assessed in this manner against the employer amount to a relatively small amount, a Government demand for taxes that are not owed is unlawful on its face and remains unlawful regardless of the amount at issue." 159 F.3d at 569 (Plager, J., dissenting).

We have held that the IRS's power to rely on estimates in making its assessment is not without bounds; rather, the IRS must use a "rational method for approximating the correct amount." *Palmer*, 116 F.3d at 1312. Where more accurate information does not exist because the taxpayer failed to maintain adequate records, or where the taxpayer has much better access to the information in question, we will generally defer to the IRS's decision as to what is a rational method for approximating the amount of tax due. But a case where the taxpayer has done everything the law requires of it, where the IRS's access to the relevant information is no worse (and probably much better) than the taxpayer's, and where the estimation method adopted by the government ignores the statutory limits on what is taxable, sorely tests the limits of that deference.

Fortunately, we need not decide whether the IRS has stretched deference to the breaking point because its assessment suffers from a more fundamental flaw:

It rests on an estimate in circumstances where Congress has not authorized the IRS to use estimation as an assessment method. *McQuatters* and similar cases relied on I.R.C. § 446, which (as already discussed) gives the IRS broad authority to use estimates in making income tax assessments. But the IRS cannot rely on section 446 as authority for the assessment here because the section does not apply to the collection of FICA taxes.

While acknowledging that section 446 is inapplicable, the Federal Circuit found it "informative" in concluding that the IRS is authorized to construct its assessment by means of estimation. *Bubble Room II*, 159 F.3d at 566. Like Judge Plager, we fail to understand "exactly how that section is informative with regard to the specific issue before us." *Id.* at 571 (Plager, J., dissenting). To the extent section 446 has any bearing at all, it suggests that the IRS here was *not* authorized to proceed by estimation. Congress obviously knew how to give the IRS the authority to use estimation in lieu of actual calculations, and just as clearly thought it necessary to say so explicitly when it wished to confer that power. Unlike our colleagues in the *Bubble Room II* majority, we do not believe such an important and sweeping power can be derived from the penumbras and emanations of the Internal Revenue Code.

The IRS points to another source of authority for its assessment, namely I.R.C. § 3121(q). This section provides that an employer is liable for its portion of FICA taxes even when "no statement including such tips is . . . furnished" or "the statement so furnished was inaccurate or incomplete." But this section doesn't help the government. All it says is that, where

employees have not provided accurate tip information to the employer, and the IRS finds some other means of determining how much the employer owes, the employer must pay its share. Nothing in the text of section 3121(q) speaks to the *method* the IRS may use in making its assessment. In fact, section 3121(q) is worded so differently from section 446 that we cannot conclude they were meant to do the same work.

The IRS points to the fact that section 3121(q) allows it to assess the employer even after the time for assessing the employee has passed. *See* Rev. Rul. 95-7, 1995-4 I.R.B. 44 (Q & A 11).[7] According to the IRS, this implicitly authorizes the use of estimates. The chain of reasoning goes something like this: If the IRS is allowed to assess the employer when it may no longer audit the employees, it will have no way to conduct the assessment except by estimation. Congress therefore must have contemplated that the IRS would proceed by estimation in making the assessments.

We do not see this as a necessary implication. Rather, we read section 3121(q) as saying that the IRS need not also conduct an audit of the employer while it is auditing the records of individual employees. Congress doubtless understood that the only way the IRS can determine FICA taxes on tips is by examining the employees' records; there's no point in auditing the

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[7] The Code does this by providing that unreported tips "shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made." I.R.C. § 3121(q). Thus, the limitations period for the assessment of the employer's FICA taxes only begins to run after notice and demand is made, even if the limitations period for the assessment of the employee's tax has expired.

restaurant at the same time because it will have no record of tips, other than the information provided by the employees in their 4070 and 8027 forms. But, if the normal limitations period applied, the IRS might have to assess the employer before it finished auditing the employees. Section 3121(q) solves this problem by keeping the period open indefinitely-which means for however long it takes to complete the audit of the restaurant's tipped employees.[8]

This does not mean that the IRS may assess the employer only if it also assesses each of its employees. Three other circuits have rejected this argument and, for reasons well expressed in those opinions, we reject it as well. *See 330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 995 (7th Cir. 2000); *Bubble Room II*, 159 F.3d at 565; *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526, 1529 (11th Cir. 1997). As the government correctly points out, the employer's portion of FICA is separate from the employee's, and the IRS need not collect the one as a condition for collecting the other. Having audited an employee and determined the precise amount of FICA wages the employee has received, the IRS may then choose to assess only the employer, only the employee, or both. If the IRS cannot or will not assess the employee for

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[8] Tying the employer's liability to the audit period for its employees also avoids the anomaly that would arise from the fact that section 3121(q) provides no time limit for assessing the employer for additional FICA taxes, making it theoretically possible that the employer could be assessed 10, 20 or more years after the tax year in question. If employer assessments are tied to employee audits, the employer can only be assessed for however long it takes to conduct audits of its various tipped employees, plus a reasonable time thereafter.

additional FICA tax, this will not jeopardize its right to assess the employer.[9]

That having been said, it does not follow that the IRS can dispense with auditing the employees' records or otherwise determining the amount each employee earned in tips. For the reasons explained, there is no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned. An aggregate assessment based on inaccurate estimates, as used by the IRS in this case, is simply not authorized.[10]

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[9] Accordingly, our holding is entirely consistent with those of the Seventh and Eleventh Circuits, both of which considered only whether the IRS must assess the employees prior to assessing the employer and not whether the IRS may rely upon aggregate estimates-the issue which is the fulcrum of our ruling. *See 330 West Hubbard Restaurant Corp.*, 203 F.3d at 994 ("On appeal, Coco Pazzo argues that the district court erred in holding that the IRS was authorized . . . to assess employer FICA taxes based on an aggregate estimate of the tip income received by its employees without first determining the amount of under reporting by individual employees."); *Morrison Restaurants*, 118 F.3d at 1529 ("Morrison Restaurants contends that, in view of Congress's silence, the IRS lacks statutory authority to assess the employer's share of FICA taxes without determining the individual employees' unreported tips and crediting the employees with the employer's share of the tax."). The Federal Circuit's decision in *Bubble Room II* is another story.

[10] The dissent worries that the IRS won't be able to collect the employer's share of FICA taxes, because it can't audit every waiter at every restaurant to determine the amount of underreporting. *See* Dissent. Op. at 858. But if this turns out to be a problem, the IRS can solve it by promulgating a regulation allowing it to assess restaurants using estimates *See* pp. 851-52 *infra*. Even without such a regulation, we are not convinced that the IRS must audit every waiter in order to ensure effective

While recognizing that "I.R.C. § 3121(q) does not fully address the question at issue here," the Federal Circuit nevertheless found that the section "would . . . seem to imply that an indirect method may be used to calculate the amount of employer FICA tax in the absence of any better evidence." *Bubble Room II*, 159 F.3d at 565.[11] The Federal Circuit derived this implication as follows: Section 3121(q) comes into play only where "no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete)." I.R.C. § 3121(q). Because the section applies where the employer's records are inadequate, the Federal Circuit reasoned, Congress must have known that the IRS would have no choice but to use an aggregate estimation method. *See Bubble Room II*, 159 F.3d at 565.

Respectfully, we disagree with our colleagues. If the employer's records are inadequate, it is because its employees have failed to report all their tips. The direct and obvious way of determining the taxable tips actually received is for the IRS to audit the employees. Proceeding by aggregate estimate, and thereby forcing the employer to pay the price for its employees' dereliction, is simply not the only (nor even the best) way the IRS may proceed. We therefore cannot agree that Congress must have had this in mind when it passed section 3121(q).

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collection of the tax. As with other taxes, a vigorous enforcement program will encourage waiters to report tips more accurately, for fear of suffering penalties if caught. Moreover, when it *does* audit waiters, the IRS can also assess the restaurant for its portion of the tax.

[11] The Federal Circuit used the term "indirect method" where we use the term "estimate." Both mean the same thing.

We are aware that auditing individual employees is much more cumbersome than slapping the employer with assessments based on aggregate estimates. The fact remains that Congress authorized the IRS to use estimates in collecting income taxes but withheld such authority in collecting FICA taxes. By using an estimate-and particularly one that ignores the statutory wages bands-and putting on the employer an impossible burden in rebutting the estimated amount, the IRS has effectively increased the tax payable by the employer above that provided in the Internal Revenue Code.[12]

Nor is the IRS without recourse. If auditing individual employees proves too cumbersome, it can seek to have Congress extend its section 446 authority to the collection of FICA taxes. Or, it may proceed by regulation. I.R.C. § 6205(a)(1) speaks to this situation:

> If less than the correct amount of tax imposed by section 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of wages or compensation, proper adjustments, with respect to both the tax and the amount to be deducted, shall be made, without interest, *in such manner and at such times as the Secretary may by regulations prescribe.*

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[12] As the Court of Federal Claims rightly remarked:

> "Even a substantially low reporting of cash tips . . . does not justify allowing the IRS to shift its responsibility to the employer for policing the acknowledged problem of underreporting of tips by employees. It is the responsibility of the IRS to track down and collect unreported income. If the IRS wishes to shift its duty to employers to ensure proper compliance, it should do so through a congressional enactment and continued cooperation between restaurants and the IRS."

Bubble Room I, 36 Fed. Cl. at 678 (Horn, J.).

Id. (emphasis added). This provision seems to authorize the Secretary to give the IRS authority to make assessments based on aggregate estimates by promulgating a regulation to that effect. But, before imposing such rough justice, the Secretary must follow the procedural requirements of notice-and-comment rulemaking.

These are not idle steps. The rulemaking process, by its very design, encourages public scrutiny of an agency's proposed course of action. By giving notice of a proposed rule, the agency provides interested parties with the opportunity to express their views and bring their political influence to bear on the process. *See* 1 Kenneth Culp Davis & Richard J. Pierce, Jr., *Administrative Law Treatise*, § 6.7 (3d ed. 1994) (noting that rulemaking enhances the "political accountability of agency policy decisions adopted through the rulemaking process"); Bernard Schwartz, *Administrative Law*, § 4.16 (2d ed. 1984) ("Rulemaking provides the agency with a forum for soliciting the informed views of those affected in industry and labor before adopting a new policy.").

The political process plays a particularly significant role in the arena of tax policy. Congress has delegated to the Secretary broad regulatory powers to adjust the legal obligations of taxpayers. *See, e.g.*, I.R.C. § 6205(a)(1). But before the Secretary can give a regulation legal force, he must endure the scrutiny of interested groups, legislative critics and the public at large. Congress maintains a particularly vigilant oversight through the Joint Committee on Taxation, whose large staff monitors and reports on the collection activities of the Department of the Treasury. *See* I.R.C. §§ 8001, 8004, 8022.

Indeed, Congress has blocked at least one of the IRS's recent efforts to enhance the collection of FICA taxes on cash tips. In 1993, the IRS promulgated a regulation that constrained restaurants' ability to take advantage of a FICA tax credit by limiting the credit to the amount of tip income received and reported by the employee (as opposed to the amount of FICA taxes paid by the restaurant). *See* Treas. Reg. § 1.45B-1T (1994). The purpose of the regulation was to give employers an incentive for encouraging employees to report their tips. *See, e.g., Fior D'Italia*, 21 F. Supp. 2d at 1103-04 (quoting Letter from Leslie B. Samuels, Assistant Secretary of the Treasury, to Senator Trent Lott (Mar. 30, 1994)). Responding to industry complaints, Congress rejected this incentive scheme in 1996 and provided that the tax credit would be available "without regard to whether such tips are reported under section 6053." I.R.C. § 45B(b)(1)(A).

This episode demonstrates the difficulty the executive and the legislative branches have had in reaching common ground on the problem of collecting taxes on employee tips. This should surprise no one, given both the substantial amount of revenue involved and the serious administrative difficulties in determining the amounts employees receive in tips. In the wake of political setbacks, the IRS has tried to solve the problem by assessing restaurants based only on the rough, and somewhat inflated, estimates that we have seen in this case. But before it can take such a significant step, it must obtain authorization directly from Congress or by exercising Treasury's own regulatory authority. Either path involves significant political checks on agency discretion, and we decline to assist the IRS in

avoiding the public scrutiny such a process would entail.

AFFIRMED.

McKEOWN, Circuit Judge, dissenting:

The issue in this case is the authority of the Internal Revenue Service to use the aggregate method of assessment for the employer's share of Social Security taxes on unreported tip income. The separate issue of the accuracy of the assessment is not before us and the two concepts-authority and accuracy-should neither be confused nor mixed and matched. In affirming the district court's rejection of the aggregate approach, the majority creates a circuit split on a tax issue of national importance. Unlike Quidditch or Fizzing Whizbees, there is nothing magical about the IRS's assessment-the employer owes taxes on the unreported tip income and the IRS has simply devised a practical means of calculating the tip income. In view of our respect for the decisions of sister circuits in tax cases, our deference to the IRS in interpreting the tax code, and the logic and practicality of the aggregate method, I respectfully dissent.

A. OTHER CIRCUITS.

The question of whether the IRS is authorized to assess the employer's share of Federal Insurance Contribution Act ("FICA") taxes, commonly known as Social Security taxes, based on the aggregate method without first determining the amount of under-reporting by individual employees is one of first impression in this circuit. Three other circuits, however, have already addressed this issue, and all three have held

that the tax code ("Code") authorizes the IRS to do so. *See 330 West Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 997 (7th Cir. 2000); *Bubble Room, Inc. v. United States*, 159 F.3d 553, 568 (Fed. Cir. 1998) (*Bubble Room II*); *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526, 1530 (11th Cir. 1997); *see also LIR Mgmt. Corp. v. United States*, 86 F. Supp. 2d 340, 346 (S.D.N.Y. 2000); *Quietwater Entm't, Inc. v. United States*, 80 F. Supp. 2d 1323 (N.D. Fla. 1999), *rev'd in part, vacated in part without op.*, 220 F.3d 592 (11th Cir. 2000).

The majority's position places the Ninth Circuit directly at odds with our sister circuits, which is of particular concern in this case, as "[u]niformity among Circuits is especially important . . . to ensure equal and certain administration of the tax system." *Hill v. Comm'r*, 204 F.3d 1214, 1217-18 (9th Cir. 2000) (internal quotation marks and citations omitted). Until now, we have "hesitate[d] to reject the view of another circuit" in this area. *Id.* (internal quotation marks and citations omitted).

Three years ago the Eleventh Circuit was the first circuit to address the question before us. In *Morrison Restaurants*, the employer sought a refund and abatement of FICA taxes assessed on unreported employee tips. 118 F.3d at 1528. The employer argued that the IRS does not have the authority under 26 U.S.C. § 3121(q) to assess its share of FICA taxes on unreported tips on an aggregate basis without first determining the under-reporting by individual employees and crediting their wage history accounts. *Id.* at 1529. This is precisely the position advocated by Fior

D'Italia. The Eleventh Circuit rejected this argument, noting that § 3121(q)

> clearly states than an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips. *It also suggests that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined.*

Id. (emphasis added). The court concluded:

> [W]e are unconvinced that Congress's silence can be construed to mean that an employer cannot be assessed its share of FICA taxes based on employees' unreported tips in the aggregate without determining the underreporting by the individual employees and crediting the individual employees' wage history accounts.

Id. at 1529-30. The Eleventh Circuit deferred to the IRS's use of the aggregate method because its interpretation of the Code was reasonable. *Id.* at 1530.

The next year, in *Bubble Room II*, 159 F.3d at 554, the Federal Circuit similarly addressed whether the IRS has the authority to assess the employer's share of FICA taxes on unreported tips on an aggregate basis "without first determining the under-reporting by the individual employees and then crediting their Social Security wage earnings records." The court concluded that the statutes authorize the IRS to do so:

> I.R.C. § 3121(q) expressly contemplates that the employer may be liable for its share of FICA taxes even if the records supplied by the employee are

> missing, inaccurate, or incomplete. Although not conclusive, § 3121(q) would thus seem to imply that an indirect method may be used to calculate the amount of employer FICA tax in the absence of any better evidence.
>
> However, I.R.C. § 3121(q) does not fully address the question at issue here-whether the particular indirect formula used by the IRS to estimate the [employer's] FICA tax liability was illegal. I.R.C. § 6201 speaks to this question. Under I.R.C. § 6201, the IRS is "authorized and required to make the inquiries, determinations, and assessments" necessary for all taxes imposed by the Code, "which have not been duly paid . . . in the manner provided by law." I.R.C. § 6201 implicitly authorizes the IRS to use an indirect formula in order to carry out the general power granted in I.R.C. § 6201. For example, the IRS would have to use an indirect formula to estimate the amount of FICA tax owed by an employer when there is no other way to "determine and assess" the wages deemed to have been paid by the employer.

Id. at 565. The Federal Circuit concluded that the statutes authorize the IRS to use the aggregate method without first determining the individual employees' tip income. *See id.* at 566-68.

Most recently, in *330 West Hubbard Restaurant*, 203 F.3d 990, 997, the Seventh Circuit addressed the issue and similarly concluded that the statutes authorize the IRS to assess the employer's share of FICA taxes based on the aggregate method without first determining the amount of under-reporting by individual

employees. The Seventh Circuit was unequivocal:

> We conclude that [the employer] has failed to demonstrate that the IRS's aggregate method of collecting employer FICA taxes is an impermissible reading of the tax code. Accordingly, we uphold the IRS's interpretation of its authority to use the aggregate method of collecting FICA taxes.

Id. at 997.

Every circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority. The majority's attempt to avoid the weight of circuit authority by suggesting that its position is somehow in line with that of *330 West Hubbard Restaurant* and *Morrison Restaurants* is transparently unsuccessful. *See* Maj. Op. at 850 n.9 ("our holding is entirely consistent with those of the Seventh and Eleventh Circuits"). As noted above, both the Seventh and Eleventh Circuits held that the IRS has the authority to use the aggregate method with respect to unreported tip income without determining the under-reporting by individual employees and crediting their wage history accounts. *See 330 West Hubbard Restaurant*, 203 F.3d at 994, 997; *Morrison Restaurants*, 118 F.3d at 1529-30. Although the majority agrees that the IRS need not assess the employees in order to assess the employer, the majority concludes that the IRS may not rely on the aggregate method and must *audit* the employees. *See* Maj. Op. at 850 & n.9. Requiring an audit is simply another way of saying that the IRS cannot estimate and that the only way the IRS can assess taxes on unreported or under-reported tips is to undertake an individual accounting of employees. This view can hardly be viewed as "entirely consistent" with

that of the Seventh and Eleventh Circuits. The IRS's authority to use the aggregate method was at the heart of the cases in those circuits. The majority's recharacterization can only pretend consistency with these cases.

B. THE IRS'S INTERPRETATION IS REASONABLE.

The Supreme Court has instructed that we must defer to an agency's interpretation of its statutes and that our review is restricted to determining whether that interpretation is reasonable. *See Chevron U.S.A. Inc. v. Natural Resources Def. Council, Inc.*, 467 U.S. 837, 843, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984) ("[I]f the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."); *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 730, 105 S. Ct. 2919, 86 L. Ed. 2d 565 (1985) ("The IRS's understanding of the terms of the Code is entitled to considerable deference."); *Bob Jones Univ. v. United States*, 461 U.S. 574, 596, 103 S. Ct. 2017, 76 L. Ed. 2d 157 (1983) ("this Court has long recognized the primary authority of the IRS . . . in construing the Internal Revenue Code"). We have likewise limited our review of IRS interpretations of the Code. *See Walthall v. United States*, 131 F.3d 1289, 1297 (9th Cir. 1997) (concluding that where the IRS's interpretation is reasonable, "[w]e must . . . show the IRS interpretation substantial deference"); *Durando v. United States*, 70 F.3d 548, 550 (9th Cir. 1995) ("Courts give deference to IRS rulings and interpretations of the Code."); *Hawkins v. United States*, 30 F.3d 1077, 1082 (9th Cir. 1994) (recognizing "the well-settled rule that an agency's interpretation of a statute is entitled to

deference unless it contradicts the statute's plain meaning").

In reviewing the IRS's interpretation of the Code, we "need not find that the agency construction [is] the only one it permissibly could have adopted to uphold the construction, or even the reading that [we] would have reached if the question initially had arisen in a judicial proceeding." *Chevron*, 467 U.S. at 843 n.11, 104 S. Ct. 2778; *accord Walthall*, 131 F.3d at 1297 (concluding that although "[t]he statute is not susceptible only to the [taxpayers'] interpretation . . . the IRS's interpretation . . . is reasonable" and "[w]e must therefore show the IRS interpretation substantial deference"). Moreover, we owe deference to the IRS's interpretation of the Code even absent a formal IRS rule. *See Alexander v. Glickman*, 139 F.3d 733, 736 (9th Cir. 1998) ("We owe deference to the agency's interpretation of the statute even absent a formal agency rule interpreting the statute.").

The IRS's interpretation of the statutes at issue here-that is, its conclusion that the statutes permit it to use the aggregate method-is reasonable in light of the statutory language. Nothing in the statutes or regulations requires the IRS to determine the amount of unreported tips before assessing the employer's FICA tax liability, and nothing in the statutes or regulations prohibits the IRS from using the aggregate method. Rather, the IRS's use of the aggregate method is *entirely consistent* with the statutes and regulations and therefore is entitled to substantial deference. A brief review of the relevant Code sections reveals that the Code does not require or bar any method, but leaves selection of the method to the agency.

Section 3111 imposes a FICA tax on employers that is computed as a percentage of wages paid by the employer to its employees. 26 U.S.C. § 3111; 26 C.F.R. §§ 31.3111-1, 31.3111-4. "Wages" includes all tips received by employees except those that amount to less than $20 in any calendar month. 26 U.S.C. § 3121(a)(12)(B), (q); 26 C.F.R. § 31.3121(a)(12)-1. Section 3121(q) requires employers to pay the § 3111 taxes on the *total* amount of tips and other remuneration, up to the Social Security wage base. *See* 26 U.S.C. § 3121(a)(1). As the Federal Circuit recognized,

> [i]n the case of the *employee* FICA tax, the employer need only consider those tips that "are included in a written statement furnished by the employee to the employer pursuant to section 6053(a)." Unlike the employee FICA tax, however, *there is no parallel provision which limits the employer's FICA tax liability to tips that are included in the written statement furnished by the employee.*

Bubble Room II, 159 F.3d at 556 (quoting 26 U.S.C. § 3102(c)) (emphasis added).

Although the statutes do not directly address whether the IRS has the authority to make aggregate assessments with respect to unreported tips, *see* Maj. Op. at 849-50, they are certainly broad enough to permit the IRS to do so. In fact, it is precisely the statutes' silence that requires *Chevron* deference. *See Chevron*, 467 U.S. at 843, 104 S. Ct. 2778. In particular, § 3121(q) provides that, even in cases where employees do not provide the employer with tip statements under 26 U.S.C. § 6053(a) or where the statements are inaccurate or incomplete, the IRS may issue a notice and de-

mand for employer FICA taxes. *See* 26 U.S.C. § 3121(q). The statute does *not* suggest, let alone require, that the IRS must first audit the employees to determine the amount of unreported tips.

This statutory silence is buttressed by § 6201's express delegation authorizing the IRS to determine and assess the amount of FICA taxes imposed by § 3111. *See* 26 U.S.C. § 6201. Specifically, § 6201(a) permits the IRS to "make the inquiries, determinations, and assessments of all taxes . . . imposed by this title." 26 U.S.C. § 6201(a). It is up to the IRS to choose the method, so long as reasonable, and it is reasonable for the IRS to conclude that the authority to determine and assess taxes includes the authority to use the aggregate method to assess the employer's taxes on unreported tips. Indeed, the IRS uses estimation methods in other contexts-specifically, to determine the amount of tips received by employees and assess a FICA tax against them under 26 U.S.C. § 446(b). Like § 6201(a), § 446(b) does not specifically authorize estimates, but § 446(b) has been interpreted to permit the IRS to use estimates to determine tax assessments. *See Bubble Room II*, 159 F.3d at 557-58. The majority posits that use of estimates with respect to employees is permissible but not so with employers. *See* Maj. Op. at 847-48. This dichotomy overlooks the fact that employers and employees have independent tax obligations with respect to tips. And, although employers arguably have a more difficult burden than employees in documenting the actual amount of tips, the implementation of estimates is a judgment best left to the IRS, not the court. The majority's approach tramples the deference owed to the IRS.

The IRS's interpretation of the statutes is also consistent with § 3111's imposition of a single tax on the employer based on the *aggregate* tips and other wages received by its employees. *See* 26 U.S.C. § 3111(a)-(b); *Bubble Room II*, 159 F.3d at 566 ("[T]he employer FICA tax imposed by I.R.C. § 3111 is expressed in terms of the employees' aggregate tip income."). Similarly, the limitations period for the assessment of employer FICA taxes is consistent with the conclusion that the IRS need *not* audit employees before assessing the employer; the limitations period does not begin to run until after notice and demand by the IRS under § 3121(q), *even if the limitations period for assessing employees has run. See* Rev. Rul. 95-7, 1995-4 I.R.B. 44 (Q & A 11). In other words, because the IRS can assess the employer even after it may no longer audit the employees, the statute implicitly authorizes the use of estimates. Although, as the majority points out, other interpretations of the statute are possible, *see* Maj. Op. at 849-50, to be reasonable, the IRS's interpretation need not rule out alternatives.

Congressional action in recent years suggests that Congress believes that the IRS has the authority to use the aggregate method as well. In 1998, Congress passed a law that prohibited the IRS from "threaten[ing] to audit [a] taxpayer in an attempt to coerce the taxpayer into entering a Tip Reporting Alternative Commitment [TRAC] Agreement." Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 685, 755 (July 22, 1998). Under the TRAC program, the employer agrees to educate its employees about tax reporting, establish procedures to ensure accurate tip reporting, and fulfill various federal tax requirements; in return, the IRS agrees to base the

employer FICA tax liability solely on reported tips and any unreported tips discovered during an IRS audit of an employee. *See* H.R. Conf. Rep. No. 105-599 at 274 (1998), U.S. Code & Cong. Admin. News at 297; S. Rep. No. 105-174 at 75 (1998); H.R. Rep. No. 105- 364 (Pt. 1) at 73 (1997). The TRAC program is a special initiative that limits the employer's liability to actual rather than estimated tips. But, in making sure that TRAC is not used as a cudgel, *Congress acknowledged the IRS's power to make aggregate calculations* of employer tax obligations, before or without making determinations with respect to individual employees.

As the majority concedes, the IRS need not *assess* each employee before it can assess the employer. *See* Maj. Op. at 849. The majority stresses, rather, that the IRS need only *audit* each employee before assessing the employer. *See* Maj. Op. at 850 & n.9. But, as the majority recognizes, employer and employee tax obligations are *completely separate. See* Maj. Op. at 850. One has nothing to do with the other. Although the employer and employee may be bound together through an employment relationship, their tax obligations arise separately. *See Bubble Room II*, 159 F.3d at 565 ("We read §§ 3101 and 3111 as imposing a separate and distinct tax liability on employers.").[1] Where

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[1] Many of Fior D'Italia's arguments against use of the aggregate method focus on employees; for example, incentives with respect to employee tip-reporting and crediting of employee Social Security accounts. But the employer and employee tax obligations are separate and not completely parallel. Whether employees report their tips and receive Social Security credit is not at issue here. If employees do not receive Social Security credit for all of their income, it is because they under-reported their income-not

the wages fall within the wages band, the employer must pay taxes on them, regardless of whether the employees reported them. *See* 26 U.S.C. § 3121(q).

The employer's independent tax obligation resonates in the structure and text of the Code. The respective employer and employee tax obligations are set forth in different subchapters. The employer's obligation is set forth in § 3111; the employees' obligation is set forth in § 3101. As previously noted, the employer's duty to collect and remit the *employees'* share of FICA taxes applies only with respect to *reported* tips—the employer's duty is not so limited. *See* 26 U.S.C. § 3102(c)(1), 3121(q). Finally, as discussed above, the limitations periods for the two tax obligations are different. *See* 26 U.S.C. § 3121(q).

The majority makes much of the IRS's lack of specific regulatory authority to use the aggregate method. But, as noted earlier, the IRS does not need to adopt a regulation in order to benefit from the deference owed to its interpretation of the Code. The majority also projects the image of a rogue IRS exercising its muscle to collect employer taxes on unreported tips, trampling on restaurants' rights and ignoring basic process. This characterization obscures the congressional dictate to tax all wages, specifically including unreported tips, and ignores the fact that the IRS's method is based on justifiable projections, not "thin air" estimates.

The majority also intimates that Congress tried to put the brakes on the IRS's effort to collect employer taxes on tips. An examination of recent legislation

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because of the aggregate method of assessing employer FICA taxes.

dispels this notion. Code § 45B generally allows an income tax credit to an employer for employer FICA taxes paid with respect to employee tips. *See* 26 U.S.C. § 45B. In 1996, Congress amended § 45B to clarify that the tax credit is available for employer FICA taxes paid on *all* tips, regardless of whether the employees reported the tips. *See* 26 U.S.C. § 45B(b)(1)(A), *as amended by* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1755, 1759 (1996). The majority reads this amendment as "demonstrat[ing] the difficulty the executive and the legislative branches have had in reaching common ground on the problem of collecting taxes on employee tips." *See* Maj. Op. at 852. But, rather than a rebuke of "the IRS's recent efforts to enhance the collection of FICA taxes on cash tips," as the majority suggests, Maj. Op. at 852, the amendment merely confirms that the employer's tax obligation is completely separate from the employees' obligation. And the amendment does more-it confirms that the IRS may impose taxes on all tips and that the employer may benefit from a tax credit on those tips, whether reported or not.

C. PRACTICALITY OF AGGREGATE METHOD.

The majority's policy arguments against the aggregate method are just that-the court making policy. Equally availing practical and policy considerations support the IRS's approach and weigh against the majority's position. For example, the majority's approach effectively prohibits the IRS from assessing the employer's share of FICA taxes with respect to unreported tips because the IRS cannot possibly audit all tipped employees to determine the degree of under-reporting. *See Bubble Room II*, 159 F.3d at 567 ("[A]s a practical

matter, the IRS lacked the resources necessary to audit each of the [employer's] tipped employees to determine the unreported tip income of each tipped employee."). The majority's approach thereby invites employers and employees alike to evade their statutory tax obligations. *See id.* ("[R]equiring the IRS to make an assessment against each employee for employee FICA taxes on unreported tips before the IRS could make an assessment against the employer for employer FICA taxes on such tips might also provide an incentive to an employer to discourage accurate reporting or to ignore clearly inaccurate reporting by its employees."); *Morrison Restaurants*, 118 F.3d at 1530 ("[B]asing the employer's share of FICA taxes exclusively on employees' reported tips would provide incentive to the employer to discourage accurate reporting or ignore blatantly inaccurate reporting by the employees so that the employer could pay less FICA tax.").

The IRS's interpretation—the one to which we owe deference—requires only that employers comply with the law; it is neither unfair nor a punishment. *See Bubble Room II*, 159 F.3d at 566 ("[W]e reject the position that the *McQuatters* formula [i.e., the aggregate method] is punitive in nature and thus limited to situations where taxpayers fail to keep adequate records."). *Cf.* Maj. Op. at 848. Employers are required, by statute, to pay their share of FICA taxes on reported *and* unreported tips. Use of the aggregate method is not an effort to tell restaurants how to run their businesses. It is simply an alternate means of assessing the tax when individual employees' records are unavailable. Restaurants can continue to pool tips or not, to require certain reporting from their employees or not, and to create a specialized tip system or

not. The choice lies with the restaurant, not the IRS. The consequence is that the tax is still owed and the IRS will impose a reasonable method to assess it. Because the IRS's conclusion that it can assess the employer's share of FICA taxes with respect to unreported tips based on the aggregate method is reasonable, we should defer to that interpretation, particularly here, in light of the need for uniformity in administering the national tax system and the views of our sister circuits.

D. USE OF THE AGGREGATE METHOD DOES NOT PRECLUDE A CHALLENGE AS TO ACCURACY AND AMOUNT.

The majority confuses the IRS's authority to use the aggregate method with the accuracy of that method. *See* Maj. Op. at 846-47, 848-49. "[W]hether there are flaws in the indirect formula used to estimate the FICA tax is a separate matter from whether the IRS has the authority to assess an employer-only FICA tax based on an aggregate estimate of unreported tip income." *Bubble Room II*, 159 F.3d at 568.

Adoption of the aggregate method does not preclude an employer from challenging the amount of the assessment by showing, for example, that some of the tips were received by employees who fell outside the wages band. *See 330 West Hubbard Restaurant*, 203 F.3d at 996 ("[The employer's] argument [regarding the wages band] is misplaced because it fails to distinguish between the IRS's authority to collect taxes and the correctness of the IRS's calculation of the amount of those taxes."); *Bubble Room II*, 159 F.3d at 567 (concluding that failure to take the wages band into account does not "make the assessment unlawful" but, rather,

"merely suggests that the amount of FICA tax assessed against [the employer] may have been incorrect by some margin and that it may be entitled to a refund of some portion of the FICA tax assessed against it"). Here, however, the issue of accuracy is not before us, because Fior D'Italia did not challenge the accuracy of the calculation-it challenged only the IRS's authority to assess taxes under the aggregate method.

The IRS is not just plucking a number out of the air and shifting the burden to the taxpayer as the majority would have us believe. Use of the aggregate method does not shift the normal burdens in some topsy-turvy manner. Instead, the aggregate method is predicated on a reasonable estimate and that may be challenged by the taxpayer. There is nothing new or unusual in this scheme of tax assessment.

* * * * * *

Our review of the IRS's interpretation of the Code is limited. Because the IRS's conclusion that it has the authority to use the aggregate method is reasonable, we must defer to it, as have three circuits before us. This approach preserves the right to challenge the accuracy of the assessment resulting from the aggregate method. Therefore, I respectfully dissent.

APPENDIX B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Filed Sept. 18, 1998]

OPINION AND ORDER ON CROSS MOTIONS FOR SUMMARY JUDGMENT

LEGGE, District Judge.

The plaintiff taxpayer challenges the Internal Revenue Service's use of a so-called "aggregate" method to determine, assess and collect an employer's share of FICA taxes on the tips received by its restaurant employees. Plaintiff has moved for summary judgment on this issue, and the government has filed a cross-motion for summary judgment on its counterclaim for the payment of the IRS's assessment. The motions were argued and submitted for decision. The court has reviewed the moving and opposing papers, the record and the applicable authorities.

I.

Plaintiff Fior D'Italia operates a restaurant in which its employees receive tips. It computes and pays its share of Federal Insurance Contribution Act ("FICA") taxes for each employee, based on each employee's salary and tip reports. Each year it files a Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips.

In 1994 the Internal Revenue Service ("IRS") sent plaintiff a Notice and Demand to pay its share of FICA taxes allegedly due on tips *not* reported by its employees for the years 1991 and 1992. The IRS computed the alleged amount of plaintiff's share by using the information on plaintiff's Forms 8027. Specifically, the IRS determined the percentage of tips on the food and services that were charged on credit cards, by dividing the total amount of tips charged by the total charges. It then estimated the total tips received by all employees, by multiplying that percentage by plaintiff's total receipts. The tips that had been actually reported to the IRS were then subtracted from that amount, to determine the estimate of *un* reported tips. That figure was then subjected to the employers' FICA tax rate of 7.65% to determine plaintiff's alleged FICA tax liability.

The IRS did not attempt to identify the amount of unreported tips of each employee. It instead used the above formula as to all of plaintiff's employees in the aggregate.

The IRS thus calculated that plaintiff owed additional FICA taxes on the aggregate unreported tips of all employees, in the amounts of $11,976 in 1991 and $11,286 in 1992. Plaintiff paid a small portion of those taxes under

protest, and then brought this suit for a refund. For purposes of this litigation, plaintiff does not dispute the facts or determinations used by the IRS to assess the aggregate unreported tip income. However, plaintiff challenges the use of the above *aggregate* method to determine its share of FICA taxes. It argues that the statutes governing FICA taxes, particularly 26 U.S.C. § 3121(q), require the IRS to determine FICA taxes for each employee *individually* in order to assess the employer's share. The government argues that the statute allows the IRS to use its aggregate method to determine the employer's share.

II.

These cross-motions for summary judgment do not dispute any facts. The parties agree that the motions turn solely on questions of statutory interpretation. The motions are therefore appropriate for resolution under Fed. R. Civ. P. 56.

A plaintiff in a tax refund action bears the ultimate burden of proving an overpayment of its taxes and the amount that it is entitled to recover. *United States v. Janis*, 428 U.S. 433, 440, 96 S. Ct. 3021, 49 L.Ed.2d 1046 (1976). The IRS's determination of a tax deficiency is presumed to be correct, and the taxpayer bears the burden of overcoming that presumption. *United States v. Barretto*, 708 F. Supp. 577, 579 (S.D.N.Y. 1989).

Here, the plaintiff taxpayer objects to the government's interpretation of Section 3121(q). As will be discussed below, the language of the statute does not directly answer the issue. And the IRS has not promulgated a regulation on the issue. It has enforced its interpretation only by making assessments against certain restaurant employers.

This court's analysis of the issue is governed by the following requirements:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress had directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43, 104 S. Ct. 2778, 81 L.Ed.2d 694 (1984). The deference given to an administrative agency's interpretation of a statute applies even if no formal regulation exists. *Alexander v. Glickman*, 139 F.3d 733, 736 (9th Cir. 1998).

Principles of statutory construction require courts to interpret a statute as a whole. *Beecham v. United States*, 511 U.S. 368, 372, 114 S. Ct. 1669, 128 L.Ed.2d 383 (1994). "In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy." *Mastro Plastics Corp. v. NLRB*, 350 U.S. 270, 285, 76 S. Ct. 349, 100 L.Ed. 309 (1956) (quot-

ing *United States v. Boisdore's Heirs*, 8 How. 113, 122, 12 L.Ed. 1009). And a court may also examine the legislative history if the meaning of the statute is not plain on its face.

III.

FICA tax payments come from two sources: (1) the employee's share, which is usually paid by deductions from an employee's wages, and (2) the employer's contribution, usually equal to the employee's share. Subchapter A of the Federal Insurance Contributions Act governs the tax on employees. 26 U.S.C. § 3101 ("there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b)) . . ."). The tax on employers is governed by Subchapter B. 26 U.S.C. § 3111 ("there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b)) . . .").

The dispute here concerns the interpretation of Section 3121(q), which states:

> (q) Tips included for both employee and employer taxes.—For purposes of this chapter, tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of subsections (a) and (b) of section 3111). Such remuneration shall be deemed to be paid at the time a written statement including such tips is furnished to the employer pursuant to

> section 6053(a) or (if no statement including such tips is so furnished) at the time received; except that, in determining the employer's liability in connection with the taxes imposed by section 3111 with respect to such tips in any case where no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary.

Plaintiff contends that this section, when read in conjunction with the rest of the code dealing with FICA taxes, does not permit an *aggregate* assessment of unreported tips to determine the employer's share, but requires an *individual* determination of the unreported tips for each employee. The government contends that nothing in the statute prohibits the use of an aggregate method, and that the IRS's method is a reasonable interpretation of the section.

Only two cases have ever addressed this question. In *Morrison Restaurants, Inc. v. United States*, 918 F. Supp. 1506 (S.D. Ala. 1996), the district court adopted the interpretation advanced by plaintiff. That decision was vacated and remanded by the Eleventh Circuit in *Morrison Restaurants, Inc. v. United States*, 118 F.3d 1526 (11th Cir. 1997), which court decided that an aggregate assessment is permitted by the statute. However, in *The Bubble Room, Inc. v. United States*, 36 Fed. Cl. 659 (1996), the Court of Federal Claims held that the IRS may not assess an employer's share of the FICA tax by using the aggregate method.

There is no case authority in this circuit.

IV.

This court starts, as it must, with the language of the section. If the meaning of the statute is clear and unambiguous on its face, the court need go no further. Here, plaintiff argues that the meaning of Section 3121(q), as well as related Section 3111, is plain.

Plaintiff points out that § 3111, which imposes the FICA tax on employers, provides that it is imposed on an employer with respect to having *individuals* in his employ, equal to the percentages of wages defined in Section 3121(a) paid "with respect to employment (as defined in section 3121(b)) . . ." (emphasis added by plaintiff). Plaintiff contends that the use of the term "individuals" is significant.

Plaintiff also highlights the definition of "employment" in Section 3121(b): "any service, of whatever nature, performed . . . by *an* employee for the person employing him." (emphasis added by plaintiff).

And plaintiff points to the language in Section 3121(q) which states that "tips received by *an* employee in the course of *his* employment shall be considered remuneration for such employment." (emphasis added by plaintiff).

Plaintiff argues from the frequent use of the singular term and from the word "individuals" that Congress intended that the IRS assess an employer's share of FICA taxes as to *each* of its employees. While certainly relevant, this argument is not conclusive, particularly in light of the rules of construction stated at the beginning of the United States Code. "In determining the meaning of any Act of Congress, unless the context indicates otherwise—words importing the singular include and apply to several persons, parties, or things;

words importing the plural include the singular. . . ." 1 U.S.C. § 1 (1994). Thus, the meaning of Section 3121(q) is not made unambiguous simply because the section uses singular nouns and articles.

The government argues that the language of the section not only allows for an aggregate assessment method, but clearly contemplates it. It notes that Section 3121(q) provides that tips are "deemed to have been paid" by the employer, and that the IRS may issue a notice and demand for the employer's share of FICA taxes even if employees fail to report their tips accurately. Specifically, the section states:

> [I]n determining the employer's liability in connection with the taxes imposed by section 3111 with respect to such tips in any case where no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the secretary.

The Circuit Court in *Morrison* found that argument significant:

> This provision clearly states that an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips. It also suggests that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined.

118 F.3d at 1529. In further support, the *Morrison* court emphasized that Congress placed the provisions imposing the employer's and employee's share of FICA taxes in separate subsections. *Id.* The court reasoned

that this placement indicated "that Congress contemplated that employees' and employer's shares could be imposed separately." *Id.*

However, that does not directly answer the question here. Even though Section 3121(q) allows the IRS to serve a demand on employers for the FICA taxes on unreported tip amounts, without also serving a demand on the employees, it does not say that the IRS may determine the employer's share through *aggregation.* That is, it does not impose the employer's obligation based on the estimated tips of *all* of the employees as a group.

The government also argues that the section provides a different statute of limitations for employers and employees. It provides that the "remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary." Subtitle F contains procedural and administrative provisions, including: the statute of limitations on assessments, I.R.C. § 6501; the timing of assessments, I.R.C. § 6201; and at what point interest begins to accrue, I.R.C. § 6601. The government contends that for employees, the tips are deemed paid when they submit a tip report to their employer or, if no report is furnished, when the tips are received, and the statute of limitations begins to run at one of those times. For employers, the tips are deemed paid when the employee submits a tip report or, if no report is furnished or if the report is inadequate, when a notice and demand is served on the employer. The government says that this extends the statute of limitations for the employer, potentially beyond the point at which the IRS could still assess unpaid taxes against the employee. The government

argues that the clause therefore anticipates that the IRS might assess unpaid FICA taxes against an employer without making a corresponding assessment against the employee.

That may well be true. But it again does not answer the question here; that is, whether the IRS can assess the FICA tax on an employer in the aggregate—for the estimated tips of *all* employees as a group.

It seems unlikely that Congress intended that the above clause of the section was for the purpose of authorizing such aggregate computation of a tax. It does not directly say so. A more likely interpretation is that the clause does only what it says it does—define the timing of assessments and when interest begins to accrue. Congress probably wanted to start the accrual of interest earlier for employees, because the employees know about their tips from the time of receipt, whereas employers should not be subject to interest accrual until they have knowledge of the unreported tips, such as when a notice and demand is made.

The court concludes that the statute, Section 3121(q) and its related I.R.C. sections, simply does not address the subject of an aggregate method of assessment that is at issue here.

V.

The court therefore turns to the legislative history of FICA taxes, the purposes of FICA, and the interaction of Section 3121(q) with other sections involving FICA taxes—particularly what they say about the FICA taxation of tips.

The United States has always subjected tips to *income* tax liability, but it did not always consider tips in determining an employee's wage earning history for

the purposes of Social Security. *Bubble Room*, 36 Fed. Cl. at 672. Congress amended the statutes in 1965 to provide that an employee's Social Security wage earning history would include tip income. *Id.* (citing Social Security Amendments of 1965, Pub. L. No. 89-97, Title III, § 313, 79 Stat. 286, 380-85 (1965) (now codified as amended in various sections of Title 26 of the U.S.C.)). The tip income would be credited to the employee's Social Security account. As a result of those amendments, tips were considered remuneration for employment and were deemed paid when a written statement of the tips was furnished to the employer; or when the tips were received by the employee, if the employee failed to provide the statement. *Bubble Room*, 36 Fed. Cl. at 672-73 (citing Social Security Amendments of 1965, Pub. L. No. 89-97, Title III, § 313(c)(4), 79 Stat. 286, 383 (1965)) (codified at I.R.C. § 3121(q)(1982)). Employers could then deduct and withhold from an employee's wages the employee's share of FICA taxes attributable to the tips. But the same tips were not then considered for purposes of the *employer's* share of FICA taxes. *Bubble Room*, 36 Fed. Cl. at 673.

In the Social Security Amendments of 1977 employers were then required to pay FICA taxes on a portion of tips received. Pub. L. No. 95-216, § 315(a), 91 Stat. 1509, 1536 (1977), *repealed by* Pub. L. No. 100-203, Title IX, § 9006(b)(2), 101 Stat. 1330-289 (1987). At that time, Sections 3111 and 3121 were amended to provide that employers must pay FICA taxes on tips up to the federal minimum wage amount. H.R. Rep. No. 95-702, 95th Cong., 1st Sess. 11 (1977), reprinted in 1977 U.S.C.C.A.N. 4155, 4168. As a result, employees were required to pay FICA taxes on all tips, but employers were required to pay FICA taxes on the employees' tip

income only up to the federal minimum wage. *Bubble Room*, 36 Fed. Cl. at 673.

Section 3121 was later amended by the Omnibus Budget Reconciliation Act of 1987, this time requiring employers to pay the same amount of FICA taxes as paid by the employees. *Id.* at 673 (citing Pub. L. No. 100-203, Title IX, § 9006, 101 Stat. 1330-288-289 (1987)). The relevant portion of the Senate Committee on Finance Print regarding that amendment to Section 3121(q) indicates that the main purpose of the amendment was to equalize the payments made by employers and employees. S. Print No. 63, 100th Cong., 1st Sess. 202-03 (1987); 133 Cong. Rec. S34,826 (1987). Congress also intended to equalize the FICA contributions of employers whose employees' receive tips with the FICA contributions of employers whose employees do not. Nothing in the legislative history indicates a Congressional intention to make employers *more* responsible than the employees for FICA taxes on tips. And nothing indicates an intention to place a tax on employers that is not credited to the employees' Social Security accounts, as the government's aggregate assessment method here would do.

Plaintiff argues that the general purpose of FICA taxes, and the manner in which the Social Security system operates, indicate that FICA taxes must be assessed on an individual basis. The system is a form of "social insurance" in which contributions are collected from current employees and employers in order to provide insurance for those who no longer support themselves through employment. *Flemming v. Nestor*, 363 U.S. 603, 609, 80 S. Ct. 1367, 4 L.Ed.2d 1435 (1960).

As the government points out, however, the eligibility for Social Security benefits does not depend en-

tirely on the amount of an employee's own contributions to the system.

> Plainly the expectation is that many members of the present productive work force will in turn become beneficiaries rather than supporters of the program. But each worker's benefits, though flowing from the contributions he made to the national economy while actively employed, are not dependent on the degree to which he was called upon to support the system by taxation.

Id. at 609-10.

Nevertheless, employees' entitlements to Social Security benefits and the amount to which they are entitled are determined by their wage earning history. *Id.* at 608. The method of assessing the employers' share of the FICA tax here, based on an aggregate of unreported tips, without attributing those amounts to the earnings records of individual employees, would not enhance the employees' later entitlement to Social Security benefits. It amounts to a tax on the employers without a commensurate benefit to the employees. The government responds that such a result is caused by the employees' own failure to make full disclosures of their tip income. While this is true, a tax on employers based on aggregate assessment without individual employee credit, operates as a general revenue tax for the government beyond the purpose of the FICA taxes.

Some evidence of the intent of Congress in Section 3121(q) can also be found in another subsection, Section 3121(a), and in another section of the Internal Revenue Code, Section 45B.

Section 3121(a) states that the term "wages" includes all remuneration for employment, but lists exceptions. Among those exceptions are "cash tips received by an employee in any calendar month . . . unless the amount of such cash tips is $20 or more." I.R.C. § 3121(a)(12)(B). Thus, tips are not "wages" for FICA tax purposes unless they are more than $20 *per employee* per month. When the IRS uses its aggregation method for determining unreported tips, it does not ascertain whether *each* employee's tips exceeded $20 and are therefore subject to the FICA tax. It cannot determine whether that exception applies unless it determines *each* employee's tip amounts.

Further, Section 45B provides a tax credit to employers equal to:

> any tax paid by an employer under section 3111 with respect to tips received by an employee during any month to the extent such tips—. . . are deemed to have been paid by the employer to the employee pursuant to section 3121(q) (without regard to whether such tips are reported under section 6053) . . .

to the extent that it exceeds the employer's tax due on the federal minimum wage rate applicable to the employee. 26 U.S.C. § 45B(b).

Essentially, employers may take a tax credit for FICA taxes paid on tips in excess of the tax due on federal minimum wage. An employer cannot take advantage of this tax credit if the IRS assesses his FICA taxes on unreported employee tips in the aggregate. The unreported tips for *each* employee must be determined in order to ascertain whether the employer has paid FICA taxes on that employee's wages in ex-

cess of the minimum wage. That provision expressly applies to situations in which the employee has failed to report or has underreported tips ("without regard to whether such tips are reported under section 6053"), and therefore anticipates that each employee's taxable wages will have been determined before the employer is required to pay FICA taxes as to that employee.

Sections 3121(a) and 45B therefore indicate that Congress intended that individual wage assessments would be made before the employer's share of FICA taxes could be assessed. Those provisions could not be applied otherwise. If the IRS were permitted to make assessments of taxes due on an aggregation of unreported tips, those credits and exemptions would become a nullity for many employers. It is a basic rule of statutory construction "that one provision should not be interpreted in a way . . . that renders other provisions of the same statute inconsistent or meaningless." *Shields v. United States*, 698 F.2d 987, 989 (9th Cir. 1983).

VI.

The government argues that disallowing the IRS's aggregate assessment method would provide an incentive to employers to encourage their employees to underreport tips. The *Morrison* court agreed. "We are concerned . . . that basing the employer's share of FICA taxes exclusively on employees' reported tips would provide incentive to the employer to discourage accurate reporting or ignore blatantly inaccurate reporting by the employees so that the employer could pay less FICA tax." 118 F.3d at 1530.

While that result could follow, nothing in the legislative history indicates that Congress had this objective

in mind when it amended Section 3121(q). *See* S. Print No. 63, 100th Cong., 1st Sess. 202-03 (1987); 133 Cong. Rec. S34,826 (1987). Rather, Congress was concerned with equalizing the taxes paid on tips by employers with those paid by employees. And as stated, nothing in Section 3121(q) expressly authorizes or compels the use of an aggregation method. Congress never suggested that its legislation was for the purpose of preventing employers from encouraging employees to underreport tips.

In fact, Congress appears to have rejected that concern in its amendments to Section 45B, the section which provides a tax credit to employers for FICA taxes paid on tips in excess of the federal minimum wage. Prior to 1996, that section did not include any mention of unreported or underreported tips, and the IRS interpreted the statute to allow an employer to take the credit only for FICA taxes paid by the employer on *reported* tips. 58 F.R. 68033, *68033. The IRS's perception of Congress's intent was explained in a letter from the Department of Treasury to the Senate:

> The temporary regulation clarifies that the credit applies only to FICA taxes paid on tips *reported to the employer by its employees.* This provision is clearly supported by the Conference Committee Report to the Omnibus Budget Reconciliation Act of 1993, which states that the credit is applicable to the employer's FICA tax obligation "attributable to *reported* tips" (emphasis added).
>
> Consistent with this Congressional intent, the temporary regulation will prevent an employer from claiming the credit for FICA taxes paid pursuant to a section 3121(q) notice and demand following a tips

> examination by the IRS. We believe that this provides the only fair and logical result and provides employers with a strong incentive for encouraging employees to report their tips.

Letter from Leslie B. Samuels, Assistant Secretary, Department of the Treasury, to Senator Trent Lott, United States Senate (March 30, 1994).

Congress expressly disclaimed this intent when it amended Section 45B in 1996, providing that the tax credit was available "without regard to whether such tips are reported under section 6053." I.R.C. § 45B(b); *see also* 61 F.R. 67212, *67213. Thus, the *Morrison* court's fear that disallowing aggregate assessment would provide an incentive to employers to encourage their employees to underreport tips was apparently not shared by Congress in 1996.

Another reason argued by the IRS for allowing its aggregation method is administrative convenience. That reason has some merit. However, administrative convenience does not guide a court's interpretation of a statute unless Congress has indicated that it shares that interest.

Both concerns of the IRS may be good reasons to persuade Congress to amend the statute. But they do not provide support for the government's interpretation of the current statute.

VII.

In summary, Section 3121(q) on its face does not clearly allow or prohibit the IRS method of assessing employer FICA taxes by aggregating unidentified employees' unreported tips. However, when Section 3121(q) is read in conjunction with other sections of the FICA statutes, as well as other sections of the Internal

Revenue Code, this court believes that Congress intended that an employer's share of FICA taxes be based on individual assessments of each employee's wages. The basic structure of the FICA tax system is to provide ultimate benefits for individual employees. The legislative history further supports this interpretation. The legislation appears generally directed at equalizing the tax burdens of employees and employers. Section 3121(q) is not just for revenue enhancement. Although this court owes deference to the IRS's interpretation of the statute, its interpretation conflicts with other statutory provisions regarding employer FICA taxes on tips. It is therefore not a permissible construction of Section 3121(q).

This court therefore grants plaintiff's motion for summary judgment and denies the United States' motion for summary judgment on its counterclaim. However, further procedures are necessary to establish the amount of the tax refund that is due to plaintiff. There will be a status conference on October 30, 1998 at 11:00 a.m. to schedule those procedures.

IT IS SO ORDERED.

/s/ CHARLES A. LEGGE
CHARLES A. LEGGE
UNITED STATES DISTRICT JUDGE

APPENDIX C

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Received: Feb. 25, 1999]

ORDER ON MOTION FOR RECONSIDERATION

The United States has moved for this court to reconsider its Opinion and Order filed on September 18, 1998. The motion is based upon a subsequent decision by the Federal Circuit in *The Bubble Room, Inc. v. United States*, 1998 WL723830 (Fed. Cir. 1998). That case, in a split decision, ruled in favor of the United States on the same issue that is involved in this case. The United States has also called to this court's attention a later decision by a district court in *330 West Hubbard Restaurant, Inc. v. United States*, No. 98-C-178 (D. Ill. November 23, 1998).

Those decisions, and other decisions cited by this court on page 6 of the Order of September 18, 1998, illustrate the difference of opinion among the four district courts and two appellate courts that have

addressed the question at issue here. There is no other decision in this circuit. While the appellate courts of the other circuits are entitled to respectful deference, this court is not bound by their holdings and respectfully disagrees for the reasons set forth in the September 18, 1998 order. The issue is both difficult and close. Assuming that the United States will continue to disagree with this court and agree with the other circuits, the issue will have to be resolved here by the Court of Appeals for the Ninth Circuit on appeal of this case, and perhaps ultimately by the United States Supreme Court.

IT IS THEREFORE ORDERED that the motion for reconsideration is denied. Since the issue of damages has not been resolved, a final judgment cannot yet be entered. A status conference is set for March 12, 1999 at 11:00 o'clock to consider what further procedures are necessary for the entry of a final judgment.

IT IS SO ORDERED.

Dated: February 23, 1999.

/s/ CHARLES A. LEGGE
CHARLES A. LEGGE
UNITED STATES DISTRICT JUDGE

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 99-16021
D.C. No. CV-97-04613-CAL

FIOR D'ITALLA, INC, PLAINTIFF-COUNTER-DEFENDANT-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-COUNTER-CLAIMANT-APPELLANT

[Filed: May 18, 2001]

ORDER

Before: KOZINSKI, KLEINFELD and MCKEOWN, Circuit Judges.

The petition for rehearing is denied: Judge McKeown would grant the petition. The full court was advised of the petition for rehearing en banc and, no judge having requested a vote thereon, the petition is denied. Fed. R. App. P. 35.

APPENDIX E

1. 26 U.S.C. 446 provides, in relevant part:

(a) General rule

Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions

If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

* * * * *

2. 26 U.S.C. 3111 provides, in relevant part:

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))—

In cases of wages paid during:	The rate shall be:
1984, 1985, 1986, or 1987	5.7 percent
1988 or 1989	6.06 percent
1990 or thereafter	6.2 percent

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on every employer

an excise tax, with respect to having individuals in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b))—

(1) with respect to wages received during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2) with respect to wages received during the calendar year 1978, the rate shall be 1.00 percent;

(3) with respect to wages received during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4) with respect to wages received during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5) with respect to wages received during the calendar year 1985, the rate shall be 1.35 percent; and

(6) with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

* * * * *

3. 26 U.S.C. 3121 provides, in relevant part:

(a) Wages

For purposes of this chapter, the term "wages" means all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash; except that such term shall not include—

(1) in the case of the taxes imposed by sections 3101(a) and 3111(a) that part of the remuneration

which, after remuneration (other than remuneration referred to in the succeeding paragraphs of this subsection) equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) with respect to employment has been paid to an individual by an employer during the calendar year with respect to which such contribution and benefit base is effective, is paid to such individual by such employer during such calendar year. If an employer (hereinafter referred to as successor employer) during any calendar year acquires substantially all the property used in a trade or business of another employer (hereinafter referred to as a predecessor), or used in a separate unit of a trade or business of a predecessor, and immediately after the acquisition employs in his trade or business an individual who immediately prior to the acquisition was employed in the trade or business of such predecessor, then, for the purpose of determining whether the successor employer has paid remuneration (other than remuneration referred to in the succeeding paragraphs of this subsection) with respect to employment equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) to such individual during such calendar year, any remuneration (other than remuneration referred to in the succeeding paragraphs of this subsection) with respect to employment paid (or considered under this paragraph as having been paid) to such individual by such predecessor during such calendar year and prior to such acquisition shall be considered as having been paid by such successor employer;

* * * * *

(q) Tips included for both employee and employer taxes

For purposes of this chapter, tips received by an employee in the course of his employment shall be considered remuneration for such employment (and deemed to have been paid by the employer for purposes of subsections (a) and (b) of section 3111). Such remuneration shall be deemed to be paid at the time a written statement including such tips is furnished to the employer pursuant to section 6053(a) or (if no statement including such tips is so furnished) at the time received; except that, in determining the employer's liability in connection with the taxes imposed by section 3111 with respect to such tips in any case where no statement including such tips was so furnished (or to the extent that the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary.

* * * * *

4. 26 U.S.C. 6053 provides, in relevant part:

(a) Reports by employees

Every employee who, in the course of his employment by an employer, receives in any calendar month tips which are wages (as defined in section 3121(a) or section 3401(a)) or which are compensation (as defined in section 3231(e)) shall report all such tips in one or more written statements furnished to his employer on or before the 10th day following such month. Such statements shall be furnished by the

employee under such regulations, at such other times before such 10th day, and in such form and manner, as may be prescribed by the Secretary.

(b) Statements furnished by employers

If the tax imposed by Section 3101 ir 3201 (as the case may be) with respect to tips reported by an employee pursuant to subsection (a) exceeds the tax which can be collected by the employer pursuant to section 3102 or section 3202 (as the case may be), the employer shall furnish to the employee a written statement showing the amount of such excess. The statement required to be furnished pursuant to this subsection shall be furnished at such time, shall contain such other information, and shall be in such form as the Secretary may by regulations prescribe. When required by such regulations, a duplicate of any such statement shall be filed with the Secretary.

(c) Reporting requirements relating to certain large food or beverage establishments

(1) Report to the Secretary

In the case of a large food or beverage establishment, each employer shall report to the Secretary, at such time and manner as the Secretary may prescribe by regulation, the following information with respect to each calender year:

(A) The gross receipts of such establishment from the provision of food and beverages (other than nonallocable receipts).

(B) The aggregate amount of charge receipts (other than nonallocable receipts).

(C) The aggregate amount of charged tips shown on such charge receipts.

(D) The sum of—

(i) the aggregate amount reported by employees to the employer under subsection (a), plus

(ii) the amount the employer is required to report under section 6051 with respect to service charges of less than 10 percent.

(E) With respect to each employee, the amount allocated to such employee under paragraph (3).

(2) Furnishing of statement to employees

Each employer described in paragraph (1) shall furnish, in such manner as the Secretary may prescribe by regulations, to each employee of the large food or beverage establishment a written statement for each calender year showing the following information:

(A) The name and address of such employer.

(B) The name of the employee.

(C) The amount allocated to the employee under paragraph (3) for all payroll periods ending within the calender year.

Any statement under this subparagraph shall be furnished to the employee during January of the calender year following the calender year for which such statement is made.

* * * * *

(4) Large food or beverage establishment

For purposes of this subsection, the term "large food or beverage establishment" means any trade or business (or portion thereof)—

(A) which provides food or beverages,

(B) with respect to which the tipping of employees serving food or beverages by customers is customary, and

(C) which normally employed more than 10 employees on a typical business day during the preceding calender year.

For purposes of paragraph (C), rules similar to the rules of subsection (a) and (b) of section 52 shall apply under regulations prescribed by the Secretary, and an individual who owns 50 percent or more in value of the stock of the corporation operating the establishment shall not be treated as an employee.

* * * * *

(6) Nonallocable receipts defined

For purposes of this subsection, the term "nonallocable receipts" means receipts which are allocable to–

(A) carryout sales, or

(B) services with respect to which a service charge of 10 percent or more is added.

* * * * *

5. 26 U.S.C. 6201 provides, in relevant part:

(a) Authority of Secretary

The Secretary is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title, or accruing under any former internal revenue law, which have not been duly paid by stamp at the time and in the manner provided by law. Such authority shall extend to and include the following:

(1) Taxes shown on return

The Secretary shall assess all taxes determined by the taxpayer or by the Secretary as to which returns or lists are made under this title.

* * * * *

Supreme Court, U.S.
FILED
NOV 16 2001
OFFICE OF THE CLERK

No. 01-463

In The

Supreme Court of the United States

UNITED STATES OF AMERICA,

Petitioner,

v.

FIOR D'ITALIA, INC.,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether judicial deference is owed to an enforcement position of four renegade IRS offices, contrary to the express directive of the IRS National Office, whereby an employer is assessed its share of FICA taxes on the tips its employees receive on the basis of an estimate of aggregate unreported tip income of all unidentified employees of the employer collectively, without regard to statutory wage exclusions available to all other employers, for the purpose of financing social security generally, in the absence of statutory, regulatory, or *any* agency interpretive authority whatsoever.

CORPORATE DISCLOSURE STATEMENT

Respondent, Fior d'Italia, Inc. has no parent corporations and there are no publicly held companies that own 10% or more of the taxpayer's stock.

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OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

Respondent, Fior d'Italia, through its attorneys, opposes the petition for writ of certiorari of the United States to review the judgement of the United States Court of Appeals for the Ninth Circuit in this case.

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The petitioner has failed to promulgate any relevant regulations. In addition to the statutory provisions identified by petitioner, the relevant portions of Sections 45B, 3101, 3102, 3121(a)(12), and 3121(b), of the Internal Revenue Code, 26 U.S.C. 45B, 3101, 3102, 3121(a)(12), and 3121(b) are set forth in the Appendix, infra, 1-6.

STATEMENT OF THE CASE

Respondent disagrees with petitioner's statement of the case in a number of respects.

Respondent intimates at pages 2-3 of its petition that employees fail to declare their tip income and employers ignore blatant underreporting in accounting for their FICA tax on tip obligations. Neither is the case. Petitioner simply misunderstands the mechanics of reporting and accounting for tip income.

Employees are required to report the tips they retain to their employers by the tenth day of the month following the month in which they are earned. 26 U.S.C.

6053(a); 26 C.F.R. 31.6053-1(a)-(c); 26 C.F.R. 31.3121(q)-1(c). Since tips are most often given to employees directly from customers and split with indirectly tipped employees (e.g., hostess, busboys, bartenders, bread girls, etc.) in varying amounts at the discretion of the directly tipped employees, employee reporting is the only way for an *employer* to know the amount of tips retained by individual employees.

Section 6053(a) is not the only means by which an employee may declare his tipped income however. An employee may declare his tips directly on his income tax return through the use of Form 4137, a form specifically designed for this purpose. There is no penalty for an employee's failure to report his tips to the employer and instead report his tip income directly to IRS on his tax return by use of Form 4137 as long as his failure is due to reasonable cause and not wilful neglect. 26 U.S.C. 6652(b). There are many legitimate, logical, practical, and lawful reasons why an employee may not report all his tips to the employer pursuant to 6053(a), yet still declare them for income tax purposes on Form 4137 when filing his income tax return.

The restaurant business is a very transient business with employee turnover rates of 200-400%. Many employees cease working for the employer long before the time to report even rolls around – certainly a legitimate reason for not reporting to the, now ex-, employer.

Reporting is often of no consequence to an employee's withholding. An employer can only withhold the employee's taxes from the funds (i.e., cash wages) within his control. 26 U.S.C. 3102(c), 3402(k); 26 C.F.R.

31.3402(k)-1(a)-(c). If an employee makes $10 per hour in tips and is paid cash wages of $2.13 per hour by the employer, the taxes on the tips will be greater than the funds available from which to deduct them, resulting in a "negative paycheck." Negative paychecks are *de rigueur* in the industry with many employees receiving their first of 52 negative paychecks the first week of the year. Under such circumstances the employee must provide a year end reconciliation of all tip income and make a lump sum payment of taxes due when filing his tax return in any event. Reporting additional amounts to his employer will not relieve him of this requirement which, as a practical matter, hardly provides the incentive for accuracy in reporting to his employer which IRS demands.

There are also many reasons an employee may not want the employer to know the total amount of tips retained. An employee may be afraid that if the employer knows the total amount of tips he receives, the employer may reduce his station or hours in favor of other employees, thereby reducing his income. A directly tipped employee may share a substantial portion of his tips with a hostess in return for seating the better tipping customers in his section or with a chef for giving his favored customers the best cut of meat – practices which neither the directly nor indirectly tipped employee would be keen about the employer discovering.

For these reasons and many others there would be nothing unusual in the total amount of tips reported by employees to employers being less than total credit card tips or less than expected. Nor would such "underreporting" mean that the tips were not declared by individual

employees on their income tax returns. It is sheer speculation to suggest that less than expected reporting of tips by employees to their employers means that there is "blatant underreporting" or even any failure to declare tip income at all.

It is also misleading to suggest that the employer turns a blind eye to "blatant underreporting" as disclosed on Form 8027 when accounting for his FICA tax on tip obligations. Form 8027 has nothing to do with the deposits of or accounting for FICA taxes on tips. Form 8027 is an informational return filed, *after the close of each year*, by which the employer reports to the IRS his gross receipts, credit card receipts, credit card tips, tips reported by employees and the shortfall between total tips reported and 8% of receipts, allocated among identified employees, in order to assist IRS in doing *its* job of examining the income of tipped employees. 26 C.F.R. 31.6053-3; H.R.Conf. Rep. No. 760, 97th Cong., 2d Sess. 556-8, reprinted in 1982 U.S. Code Cong. & Ad. News 1328-30.

An employer's FICA taxes on wages paid and tips "deemed paid" by virtue of an employee's reporting to the employer, on the other hand, are deposited on a daily, semi-weekly, or monthly basis depending on the size of the employer's payroll, 26 C.F.R. 31.6302-1, and accounted for on a quarterly basis, 26 C.F.R. 31.6011(a)-1, and 31.6071(a)-1, *continuously throughout the year*, i.e., long before the information on Form 8027, which petitioner argues makes "blatant underreporting" obvious, is known or available. Form 8027, due annually on February 28, is completed after payroll tax deposits are made, quarterly payroll tax returns are filed, and even

employees' W-2's showing total tips reported throughout the year, are finalized and sent to employees and filed with IRS and the social security administration. It is silly to suggest that the employer ignores blatant underreporting in his near daily payroll tax obligations when the information he is accused of ignoring will not be available for many months after the fact.

The only information available to the employer and indeed the only information upon which the law allows him to rely in fulfilling his FICA tax obligations on tip income on a payroll by payroll basis during the course of the year, is the reports of such income by individual employees. Petitioner's specious suggestion that the employer has any option, either practically or legally, but to base his FICA tax on tips obligations on anything but individual employee tip reports is an untenable ruse designed to make the restaurant employer appear scofflaw. He is not.

Petitioner also argues that respondent did not dispute the reasonableness or accuracy of the Service's calculation of the amount of unreported tips. One wonders how we find ourselves at the court house door if such was the case.

Respondent agrees only that IRS's calculation of tip income unreported by employees in the aggregate was reasonable. However that says nothing about the amount of tax an employer owes on the unreported tip income, if any, of his employees pursuant to 26 U.S.C. 3121(q).

There is no way to determine under IRS's aggregate calculation how much, if any, of the aggregate unreported tip income was tip income received by an individual

employee amounting to less than $20.00 a month, 26 U.S.C. 3121(a)(12), nor how much of the aggregate unreported tip estimates by IRS was received by individual employees which when added to such individual employee's other wages paid by the employer exceeded the wage base, 26 U.S.C. 3121(a)(1), nor how much of the IRS aggregate unreported tip estimate was received by individual employees in excess of the federal minimum wage for which the employer is entitled to a tax credit as provided under 26 U.S.C. 45B.

Nor would such a method tell one whether individual employees received tips net of credit card fees often charged by many employers[1] or whether employees received any tips on "employee meals" or "carry-out" sales, figures often included in a restaurant's gross receipts but upon which tips are seldom received. Nor would such a methodology provide information about a company's policy with respect to "walk-outs" or "stiffs"

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[1] Petitioner argues at page 16 that California statutes expressly prohibit this practice and that this "flaw" in the IRS's methodology was of the court of appeals own conjecture. Petitioner is in error. The cited statute is new and became effective after the Ninth Circuit's decision. Prior to the changes in the law, and during the years in issue in this proceeding, a California employer was permitted to subtract the amount of the fee charged by credit card companies from an employee's tips. *Labor Commissioner of California v. Specialty Restaurants Corp.*, No. AP-11668 of the Appellate Division Superior Court of California, County of Orange, Feb. 20, 2001; Case No 99CL 002828, 99CL 004461, Superior Court of the State of California For the County of Orange, Central Justice Center, Nov. 18, 1999. This procedure is also permitted under the Fair Labor Standards Act. Wage and Hour Field Operations Handbook ¶ 30d05(a).

figures often included in gross receipts for financial purposes then expensed, but upon which tipping is unlikely. Nor would an aggregate assessment based on Form 8027 data give any information as to whether a portion of a restaurant's sales are self-service or buffet at different times of the day, factors which would vastly affect the tip rate.

To make a reasonable estimate in the aggregate for all employees is not to make a reasonable estimate of the unreported tips upon which the employer tax may be lawfully assessed. Taxpayer's concession is not an admission that any employer FICA taxes are due, or that all, or even part, of aggregate unreported tips as determined by IRS, were not reported directly to IRS by some employees or that some of those aggregate tips were not wages subject to employer FICA taxes because they amounted to less than $20.00 a month or exceed the social security wage base, when added to the cash wages of individual employees.

Petitioner also states that respondent insists that IRS base its assessment on employers on audits of individual employees. Respondent has never advanced such an argument. It is not necessary that IRS audit individual employees as the Ninth Circuit recognized. Petitioner's App. 13a n.10.

Certainly IRS could collect a substantial amount of its alleged shortfall by simply sending employers a bill for their share of FICA taxes on the additional tips their employees report on Forms 4137 (see infra pg. 2-3). Additional amounts could also readily be collected by pursuing by letter, the list of employees provided IRS annually

to whom an allocation was made, as intended by Congress (see infra pg 4). To the extent perceived additional unreported amounts warrant further pursuit, "desk" audits could be undertaken by sending the identified employees computer generated assessments for amounts in excess of the allocation.

All of these options are available to IRS at minimal time and expense with the crucial distinction of identifying individual employees and amounts of any additional tip earnings of individual employees so their wage earnings records for social security benefit purposes could be credited for such additional amounts with greater assurances that the amounts assessed were actually received by the individual employees.

What's so hard about that?

REASONS WHY THE PETITION SHOULD BE DENIED

1. Uniformity and Disparate Treatment

Petitioner argues that "Resolution of this conflict by this Court is needed to preserve uniform application of the FICA tax throughout the Nation and to avoid disparate treatment of similarly situated taxpayers based solely upon the happenstance of their geographical location." Petition pg. 6.

Certainly the authority to send every restaurant employer in the country a bill for additional FICA taxes on tips on the basis of a determination that tipped employees nationwide earn an average of 12.5% of sales (See, *Tip Income Study: A Study of Tipping Practices in the*

Food Service Industry for 1984, Department of Treasury, Internal Revenue Service, Research Division, Publication 1530 (8-90) Catalog No. 12482K7) with the onus on the employer to prove otherwise, would greatly reduce IRS administrative burden while ensuring that everyone pays on *exactly* the same basis. Although it remains to be seen, even respondent does not fathom that this is what the IRS has in mind.

Rather, it would appear petitioner seeks the authority to unleash thousands of untrained IRS agents, wholly unfamiliar with the nuances of vastly varying restaurant operations and tipping practices and procedures, on the hundreds of thousands of restaurants across the country in order to *ensure* that the determination of individual restaurant employers' FICA tax on tips obligations are made on the basis of uniform consistent principles and application of the tax laws, even though no guidance whatsoever as to how that determination is to be made is anywhere to be found. It is hard to imagine what could lead to greater disparate treatment than that.

If IRS wishes to ensure uniformity and eliminate disparate tax treatment it should do exactly what the Ninth Circuit suggested – promulgate regulations – rather than seek nationwide endorsement of a misguided, indefensible, enforcement methodology developed at the whim of a few rogue revenue agents.

2. Employment Tax Statutes

Petitioner argues that the fact that there is a separate tax on employees and employers, which can be collected at different times, and the fact that the employer owes

taxes on all tips received not just reported, provides statutory authority for an aggregate assessment of all employees of the employer collectively. Such a quantum leap stretches statutory construction analysis beyond its limits.

Both the employer and employee owe FICA taxes on exactly the same thing: tips received by an individual employee whether reported to the employer or not. 26 U.S.C. 3101, imposing the employee tax, and 26 U.S.C. 3111, imposing the employer tax, define "wages" with respect to "employment" subject to both taxes by reference to the exact same definitional sections: 26 U.S.C. 3121(a) and (b). Petitioner would have this court believe that these sections define wages for the employer's share of taxes differently from the employee's share, to wit, "all wages from employment." Petitioner would like this court to construe such language as "*all* remuneration from employment of *all* employees *collectively*." But petitioner fails to quote the relevant portions of the statute.

The tax is imposed "on the income of every ***individual***" under 3101 and on the "wages . . . paid by [the employer] with respect to . . . [the] service . . . performed . . . by ***an employee*** . . . in the course of ***his*** employment" (26 U.S.C. 3111, 3121(b) and (q), emphasis added).

Specifically, 26 U.S.C. 3111(a) and (b) provides:

> . . . there is hereby imposed on every employer an excise tax, with respect to having *individuals* in his employ, equal to the following percentages of the wages (as defined in section 3121(a)) paid by him with respect to employment (as defined in section 3121(b)) – . . . .

26 U.S.C. 3121(a) defines "wages" as "all remuneration for employment" except for 21 enumerated statutory exceptions. 26 U.S.C. 3121(b) defines "employment" as "any service, of whatever nature, performed . . . by *an* employee for the person employing him".

26 U.S.C. 3121(q) defines "tips received by *an* employee in the course of *his* employment shall be considered remuneration for such employment" (emphasis added).

Thus, this clear statutory language provides that tips received by *an* employee are remuneration, which after being adjusted by the statutory exclusions from remuneration (which *must* be computed on the basis of individual earnings, see 26 U.S.C. 3121(a)(1)-(21)), are considered wages for purposes of the imposition of both the employer's and employee's FICA taxes. Only after an employee's "wages" have been computed and all exclusions from the definition of wages (which the IRS interpretation eliminated) have been accounted for, can the "wages" be subjected to FICA for both employer and employee purposes.

Petitioner makes much of the fact that employers owe taxes when employees fail to accurately report their tips to the employer and that under such circumstances the employer owes its share of taxes at a later date. Petitioner's argument is that this fact somehow redefines what the employer owes. According to petitioner, if employees report the tips to the employer, the employer owes FICA taxes on the tips received by individual employees; if the employee fails to report the tips however, the employer's obligations are somehow redefined

to apply to all tips of all employees in the aggregate as estimated by IRS. Petitioner reads too much into the provision.

The reason why the employer owes the tax on tips received, but unreported to him by employees, at a later date is simple: the employer can't be liable for what he does not know exists until he knows that it exists.

The payment of wages triggers a plethora of procedural and record keeping obligations. Tips are "deemed" paid when reported. Once wages are "paid," tax deposits are required, quarterly forms must be filed, interest, penalties and the statute of limitations kicks in, etc. If the received but unreported tips were "deemed" paid when the reports were due, an employer would be subject to deposit and reporting obligations and all ensuing penalties for failure to satisfy obligations which he does not know, and cannot know, exist. Obviously the unreported and unknown tips cannot be "deemed" paid, thereby setting in motion an employer's FICA system responsibilities, until he has some clue that they even exist.

Language which prevents such a scenario can hardly be read as permitting IRS to ignore all statutory exclusions from income and allowing aggregate assessments of all employees collectively however.[2] There simply is no

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[2] Similarly, petitioner's reference to 26 U.S.C. 3102(c) is nonsensical. Of course a provision which addresses "negative paycheck" situations and clarifies that the employer is not responsible for satisfying an employee's income tax obligations from his own funds when the cash wages owed to the employee

statutory authority for IRS's position. It strains credibility to suggest that there is and no court has so held.

3. Aggregate Assessments

Petitioner argues that there is no authority for the court's holding that aggregate assessments are impermissible, that nothing in the statute requires the IRS to make individual determinations, and that IRS's general authority under 26 U.S.C. 6201 provides it with the right to make aggregate assessments of the income of all employees collectively. In short, petitioner argues that since no statute specifically prohibits assessing on the basis of aggregate estimates, it can. Taken to its logical conclusion, if Petitioner's argument were sound, IRS could, of course, forgo individual audits altogether and apply the same rationale to the collection of all taxes. However, petitioner's argument turns IRS's authority on its head.

Petitioner argues that the court of appeals can cite no authority for its conclusion that IRS *has* no authority. What a fatuous contention! Obviously IRS only has the authority specifically granted to it by Congress. If it was never granted it is not there to be found.

Petitioner nonetheless argues that IRS's authority is implicit in 26 U.S.C. 6201. Ironically, it is this very section upon which IRS bottoms its authority which clearly and unequivocally denies it. Once again petitioner fails to

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are inadequate to cover the employee's withholding obligations, would be totally irrelevant in the context of the payment of the *employer's* share of FICA taxes.

inform this Court of the relevant statutory provisions. 26 U.S.C. 6201 provides: "The Secretary is authorized ***and required*** to make the inquiries, determinations, and assessments of all taxes. . . . " The section may *broadly* "authorize" IRS to choose a reasonable method but there is no questions it also *specifically, "requires"* IRS to make the *very same* inquiries and determinations that IRS *insists* there is no authority to require it to do here.

IRS whines that it has no recourse but to do aggregate assessments because "accurate and complete records showing the amount of tips do not exist". IRS wouldn't know one way or the other and certainly has many far more palatable options available than the one chosen here (see infra pg. 7-8).

Petitioner argues there is no difference between an assessment based upon an aggregate estimate and one on individual audits because an aggregate assessment is nothing more than the sum of individual assessments. Any perceived differences, petitioner continues, are conjecture and in any event may be challenged by the taxpayer.

Make no mistake; respondent's complaints are no canard.

As set forth above and for the reasons set forth in excruciating detail in IRS study of tipping practices (see *Tip Income Study*, supra.), "flaws" permeate IRS's aggregate estimating methodology and are of such a nature that the employer is wholly without the information (which he was not privy to in the first place) to challenge them.

The difference between an assessment issued directly from an IRS agent's desk to a 1000 unit restaurant chain for its employer share of FICA taxes on the basis of an aggregate estimate of unreported tips of all of the company's hundreds of thousands of employees over the last 13 years collectively, without any information with which to mount a defense or determine individual tips earnings, and an assessment based upon the determinations of individual tips earnings, is astronomical by anyone's definition.

Yet petitioner argues that Congress gave tacit approval to the possibility of just such an assessment in 1998 when enacting restrictions on IRS's promotion of TRAC agreements. Such an inference is not only flatly contradicted by Congress's action only months earlier with regard to changes to 26 U.S.C. 45B (see petitioner's App. 17a and 46a-50a) but an implausible inference in light of the fact that employer-only assessments based on aggregate estimates were prohibited by IRS National Office at the time Congress was considering and enacted its restriction on the promotion of TRAC agreements.[3]

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[3] In a memo from Thomas J. Smith, Assistant Commissioner (Exam), to IRS Regional Chief Compliance Officers dated December 11, 1996, the field was notified:

> We can no longer have employer-only assessments. Any assessments made should be based on amounts from either Form 4137, *Social Security and Medicare Tax on Unreported Tip Income* (filed by the employee with the employee's Form 1040) or amounts reflected on Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer*, prepared at the conclusion of an employee tip examination.

IRS aggregate assessments are flawed and authorized by neither statute nor administrative policy. Not only does IRS have viable alternatives, pursuing such alternatives is statutorily mandated.

4. The Necessity for Review

Petitioner argues that this Court's review is required because the judgement of the Ninth Circuit "invites employers and employees alike to evade their statutory tax obligations," a fact, according to petitioner, aggravated by a split in the circuits.

The figures quoted by petitioner at page 20 which show a 170% increase in the amount of tips reported during the precise time period that IRS National Office had a strict policy against employer-only assessments based on aggregate estimates of all employees (see fn. 3 supra) belies the suggestion that aggregate assessments are a critical enforcement tool in IRS's arsenal.

This position was reiterated in a memo dated June 16, 1998 from Tom Burger, Director, Office of Employment Tax Administration & Compliance (OETAC):

> . . . We wish to emphasize these policy procedures again. Any assessment made against the employer must mirror those first made against individual employees. . . . We have received congressional inquiries that employer-only assessments are still being performed by IRS examiners, although our current policy prevents this. Please insure that all affected IRS personnel working on the Tip Initiative follow the current procedures related to tip examinations.

While the decisions of other circuits are certainly in need of correction and clarification, such need does not warrant upsetting the sound judgement of the Ninth Circuit. The more prudent course is to wait the resolution of the cases currently pending in the First and Second Circuits involving the same issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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November 16, 2001

APPENDIX

1. 26 U.S.C. 45B provides, in relevant part:

(a) General rule. –

For purposes of section 38, the employer social security credit determined under this section for the taxable year is an amount equal to the excess employer social security tax paid or incurred by the taxpayer during the taxable year.

(b) Excess employer social security tax –

For purposes of this section –

(1) In general. –

The term 'excess employer social security tax' means any tax paid by an employer under section 3111 with respect to tips received by an employee during any month, to the extent such tips –

(A) are deemed to have been paid by the employer to the employee pursuant to section 3121(q) (without regard to whether such tips are reported under section 6053), and

(B) exceed the amount by which the wages (excluding tips) paid by the employer to the employee during such month are less than the total amount which would be payable (with respect to such employment) at the minimum wage rate applicable to such individual under section 6(a)(1) of the Fair Labor Standards Act of 1938 (determined without regard to section 3(m) of such Act).

(2) Only tips received for food and beverages taken into account. –

In applying paragraph (1), there shall be taken into account only tips received from customers in connection with the providing, delivering, or serving of food or beverages for consumption if the tipping of employees delivering or serving food or beverages by customers is customary.

(c) Denial of double benefit. –

No deduction shall be allowed under this chapter for any amount taken into account in determining the credit under this section.

(d) Election not to claim credit. –

This section shall not apply to a taxpayer for any taxable year if such taxpayer elects to have this section not apply for such taxable year."

* * *

2. 26 U.S.C. 3101 provides, in relevant part:

(a) Old-age, survivors, and disability insurance

In addition to other taxes, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b)) –

In cases of wages received during:	The rate shall be:
1984, 1985, 1986, or 1987.....	5.7 percent
1988 or 1989.....	6.06 percent
1990 or thereafter.....	6.2 percent

(b) Hospital insurance

In addition to the tax imposed by the preceding subsection, there is hereby imposed on the income of every individual a tax equal to the following percentages of the wages (as defined in section 3121(a)) received by him with respect to employment (as defined in section 3121(b)) –

(1) with respect to wages received during the calendar years 1974 through 1977, the rate shall be 0.90 percent;

(2) with respect to wages received during the calendar year 1978, the rate shall be 1.00 percent;

(3) with respect to wages received during the calendar years 1979 and 1980, the rate shall be 1.05 percent;

(4) with respect to wages received during the calendar years 1981 through 1984, the rate shall be 1.30 percent;

(5) with respect to wages received during the calendar year 1985, the rate shall be 1.35 percent; and

(6) with respect to wages received after December 31, 1985, the rate shall be 1.45 percent.

* * *

3. 26 U.S.C. 3102 provides, in relevant part:

Sec. 3102. Deduction of tax from wages

(a) Requirement

The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid. . . . An

employer who in any calendar year pays to an employee cash remuneration to which paragraph (7)(B) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar year is less than the applicable dollar threshold (as defined in section 3121(x) for such year; and an employer who in any calendar year pays to an employee cash remuneration to which paragraph (7)(C) or (10) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar year is less than $100; and an employer who in any calendar year pays to an employee cash remuneration to which paragraph (8)(B) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar year is less than $150 and the employee has not performed agricultural labor for the employer on 20 days or more in the calendar year for cash remuneration computed on a time basis; and an employer who is furnished by an employee a written statement of tips (received in a calendar month) pursuant to section 6053(a) to which paragraph (12)(B) of section 3121(a) is applicable may deduct an amount equivalent to such tax with respect to such tips from any wages of the employee (exclusive of tips) under his control, even though at the time such statement is furnished the total

amount of the tips included in statements furnished to the employer as having been received by the employee in such calendar month in the course of his employment by such employer is less than $20.

(b) Indemnification of employer

Every employer required so to deduct the tax shall be liable for the payment of such tax, and shall be indemnified against the claims and demands of any person for the amount of any such payment made by such employer.

(c) Special rule for tips

(1) In the case of tips which constitute wages, subsection (a) shall be applicable only to such tips as are included in a written statement furnished to the employer pursuant to section 6053(a), and only to the extent that collection can be made by the employer, at or after the time such statement is so furnished and before the close of the 10th day following the calendar month (or, if paragraph (3) applies, the 30th day following the year) in which the tips were deemed paid, by deducting the amount of the tax from such wages of the employee (excluding tips, but including funds turned over by the employee to the employer pursuant to paragraph (2)) as are under control of the employer.

* * *

4. 26 U.S.C. 3121(a)(12) provides, in relevant part:

Sec. 3121. Definitions . . .

(12)(A) tips paid in any medium other than cash;

(B) cash tips received by an employee in any calendar month in the course of his employment by an

employer unless the amount of such cash tips is $20 or more;

* * *

5. 26 U.S.C. 3121(b) provides, in relevant part:

(b) Employment

For purposes of this chapter, the term "employment" means any service, of whatever nature, performed (A) by an employee for the person employing him, . . .

Supreme Court, U.S.
FILED
NOV 21 2001

No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

THEODORE B. OLSON
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202)514-2217

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No. 01-463

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REPLY BRIEF FOR THE UNITED STATES

Respondent does not deny that there is an irreconcilable conflict among the circuits on the question presented in this case. Respondent instead submits that the appellate decisions that have disagreed with "the sound judgement of the Ninth Circuit" in this case simply reached the wrong conclusion. Br. in Opp. 17. Although respondent asserts that the appellate decisions that conflict with the decision in this case are "certainly in need of correction," respondent suggests that the "correction" of these conflicting decisions should not be done yet, but should instead "wait the resolution" of other cases presenting the same issue that are now pending in other circuits. *Ibid.*

In short, respondent acknowledges that there is a current conflict involving several circuits on this recurring issue and that the litigation involving this issue continues to spread into additional courts. The fact that respondent disagrees with the decisions of other circuits on the merits does not eliminate or diminish the need for resolution of this recurring issue by this Court. As we explain in the petition, the question presented in this case has significant and widespread importance, for it affects numerous taxpayers and involves a "substantial amount of revenue." Pet. App. 17a; see Pet. 19.

* * * * *

For these reasons, and the additional reasons set forth in the petition, it is therefore respectfully submitted that the petition for a writ of certiorari should be granted.

THEODORE B. OLSON
Solicitor General

NOVEMBER 2001

Supreme Court, U.S.
FILED
FEB 22 2002
CLERK

No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI FILED: SEPT. 14, 2001
CERTIORARI GRANTED: JAN. 7, 2002

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* The opinion of the court of appeals, the opinion and order of the district court on cross motions for summary judgment, and the order of the district court on motion for reconsideration are printed in the appendix to the petition for writ of certiorari and have not been reproduced here.

TAB A

UNITED STATES DISTRICT COURT FOR
THE NORTHERN DISTRICT OF CALIFORNIA (S.F.)

No. 97-CV-4613

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

DOCKET ENTRIES

DATE	DOCKET NUMBER	PROCEEDINGS
12/18/97	1	COMPLAINT (Summons Issued); Fee status paid entered on 12/18/97 in the amount of $150.00 (Receipt No. 129782) [3:97-cv-04613] (tn) [Entry date 12/23/97]
12/18/97	2	ORDER by Judge Charles A. Legge setting status conference for 11:00 a.m. on 4/3/98 (cc: all counsel) [3:97-cv-04613] (tn) [Entry date 12/23/97]
1/13/98	3	RETURN OF SERVICE executed upon the U.S. Attorney General and the U.S. Attorney's Office for the Northern Dist. Of CA on

DATE	DOCKET NUMBER	PROCEEDINGS
		behalf of defendant USA served by certified mail on 1/12/98 [3:97-cv-04613] (tn) [Entry date 01/15/98]
3/26/98	4	CASE MANAGEMENT STATEMENT and PROPOSED ORDER filed by defendant [3:97-cv-04613] (tn) [Entry date 03/27/98]
4/3/98	5	MINUTES: (C/R Not Reported) Hearing Date 4/3/98) Case management conference - held, the United States needs to get authority for a counterclaim, and is currently waiting to receive it, matter was continued to 5/29/98 at 9:30 a.m. for cross-motion for summary judgment (4/24/98 - plaintiff's motion, 5/8/98- Gov't. opposition/ cross-motion for summary judgment & reply due 8/15/98 [3:97-cv-04613] (tn) [Entry date 04/07/98]

DATE	DOCKET NUMBER	PROCEEDINGS
4/28/98	6	ANSWER by defendant to plaintiff's complaint [1-1] [3:97-cv-04613] (tn) [Entry date 05/04/98]
4/28/98	6	COUNTERCLAIM by defendant against Plaintiff [3:97-cv-04613 (tn) [Entry date 05/04/98]
4/28/98	—	SUMMONS on a counterclaim issued as to Counterdefendant Fior D'Italia, Inc. [3:97-cv-04613] (tn) [Entry date 05/04/98]
5/6/98	7	STIPULATION and ORDER by Judge Charles A. Legge: extending time for plaintiff to 05/15/98 to file its motion for summary judgment, All motions will be heard by 9:30 6/19/98; (cc: all counsel) [3:97-cv-04614] (rs) [Entry date 05/14/98]
5/18/98	—	RECEIVED Proposed Order by Plaintiff Fior D'Italia, Inc. for attorney Tracy Power to appear Pro Hac Vice [3:97-cv-04613] (awb)

DATE	DOCKET NUMBER	PROCEEDINGS
5/18/98	8	NOTICE OF MOTION AND MOTION by Plaintiff Fior D'Italia, Inc. for summary judgment and brief in support thereof; Motion to be heard 6/19/98 at 9:30 before the Honorable Charles Legge [3:97-cv-04613] (awb)
5/18/98	—	RECEIVED Proposed Order by Plaintiff Fior D'Italia, Inc. re: motion for summary judgment [8-1] [3:97-cv-04613] (awb)
5/19/98	9	APPLICATION before Judge Charles A. Legge by Plaintiff for attorney Tracy J. Power to appear pro hac vice [3:97-cv-04613] (tn)
5/19/98	9	ORDER by Judge Charles A. Legge granting plaintiff's application for attorney Tracy J. Power to appear pro hac vice [9-1] (cc: all counsel) [3:97-cv-04613] (tn)
5/19/98	10	LETTER dated 5/15/98 from Tracy J. Power to Clerk regarding filing of affidavit of James M. Bril [3:97-cv-04613] (tn)

DATE	DOCKET NUMBER	PROCEEDINGS
5/19/98	11	AFFIDAVIT of James M. Bril on behalf of plaintiff [3:97-cv-04613] (tn)
5/20/98	12	REPLY/ANSWER TO COUNTERCLAIM [6-1] by Plaintiff & Counter-defendant Fior D'Italia, Inc. [3:97-cv-04613] (tn)
5/29/98	13	CROSS-MOTION by defendant for summary judgment, with Notice set for 9:30 a.m. on 6/19/98 [3:97-cv-04613] (tn) [Entry date 06/02/98]
5/29/98	13	MEMORANDUM by defendant in opposition to plaintiff's motion for summary judgment [8-1], and in support of its cross-motion for summary judgment [3:97-cv-04613] (tn) [Entry date 06/02/98]
5/29/98	14	DECLARATION of Thomas Moore on behalf of defendant re opposition memorandum [13-1], re cross-motion for summary judgment [3-1] [3:97-cv-04613] (tn) [Entry date 06/02/98]

DATE	DOCKET NUMBER	PROCEEDINGS
6/8/98	15	RESPONSE (Brief) by Plaintiff Fior D'Italia, Inc. in opposition to defts' motion for summary judgment [13-1] [3:97-cv-04613] (awb) [Entry date 06/10/98]
6/19/98	16	MINUTES: (C/R Kathy Wyatt) (Hearing Date: 6/19/98) that the cross-motion for summary judgment [13-1] is submitted; the court will issue a written opinion [3:97-cv-04613] (tn) [Entry date 06/22/98]
9/18/98	17	OPINION AND ORDER ON CROSS MOTIONS FOR SUMMARY JUDGMENT by Judge Charles A. Legge denying defendant's cross-motion for summary judgment [3-1], and granting plaintiff's motion for summary judgment [8-1]; however, further procedures are necessary to establish the amount of the tax refund that is due to plaintiff, and status conference set for 11:00 a.m. on 10/30/98 to

DATE	DOCKET NUMBER	PROCEEDINGS
		schedule those procedures (Date Entered: 9/23/98) (cc: all counsel) [3:97-cv-04613] (tn) [Entry date 09/23/98]
10/26/98	18	NOTICE OF EXPEDITED MOTION before Judge Charles A. Legge by defendant for leave to file motion to reconsider with Notice set for 9:30 a.m. on 10/30/98 [3:97-cv-04613] (tn)
10/28/98	19	EXPEDITED MOTION by Judge Charles A. Legge by Plaintiff to postpone status conference until the court rules on defendant's expedited motion for leave to file motion for reconsideration [3:97-cv-04613] (tn)
10/28/98	20	OPPOSITION by Plaintiff to defendant's motion for leave to file motion to reconsider [18-1] [3:97-cv-04613] (tn)

DATE	DOCKET NUMBER	PROCEEDINGS
11/13/98	—	ORDER by Judge Charles A. Legge granting defendant's motion for leave to file motion to reconsider [18-1]. Defendant may file motion for reconsideration, and a brief in support of it, by 11/30/98. Plaintiff may file a reply by 12/15/98. The motion and the reply must be limited to the effect of the Federal Circuit's decision on the reasoning of this court's opinion and order of 9/18/98 (cc: all counsel) [3:97-cv-04613] (tn) [Entry date 11/18/98]
11/30/98	22	MOTION WITH MEMORANDUM OF LAW before Judge Charles A. Legge by defendant for reconsideration [3:97-cv-04613] (tn)
12/15/98	23	OPPOSITION by Plaintiff to defendant's motion for reconsideration [22-1], and memorandum of law in support thereof [3:97-cv-04613] (tn) [Entry date 12/24/98]

DATE	DOCKET NUMBER	PROCEEDINGS
2/23/99	24	ORDER by Judge Charles A. Legge DENYING defendant's motion for reconsideration [22-1], and status conference set for 11:00 a.m. on 3/12/99 (Date Entered: 2/26/99) (cc: all counsel) [3:97-cv-04613] (tn) [Entry date 02/26/99]
3/8/99	25	STIPULATION and ORDER by Judge Charles A. Legge: that judgment is entered against the United States of America and in favor of plaintiff for the 1994 Tax year for form 941 employment taxes in the amount of $18.34 together with interest thereon at the lawful rate prescribed by 28 U.S.C. Section 1961(c)(1) from 2/1/95 until paid, and terminating case [Date Entered: 3/15/99] (cc: all counsel)

DATE	DOCKET NUMBER	PROCEEDINGS
5/7/99	26	NOTICE OF APPEAL by defendant USA from Dist. Court decision order [25-2], [24-2] & [17-2]; Fee status waive/government [3:97-cv-04613 (tn) [Entry date 05/11/99]
5/7/99	—	RECEIVED Civil Appeals Docketing Statement submitted by defendant USA re: appeal [26-1] [document forwarded to USCA] [3:97-cv-04613] (tn) [Entry date 5/11/99]
5/7/99	27	TRANSCRIPT DESIGNATION and Ordering Form filed by defendant USA – not designating any portion of the transcript; C/R: None; appeal [26-1] [3:97-cv-04613] (tn) [Entry date 05/11/99]
6/1/99	–	NOTIFICATION by Circuit Court of Appellate Docket Number 99-16021 [3:97-cv-04613] (tn) [Entry date 06/02/99]

TAB B

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 99-16021

FIOR D'ITALIA, INC.,
PLAINTIFF-COUNTER-DEFENDANT-APPELLEE

v.

UNITED STATES OF AMERICA,
DEFENDANT-COUNTER-CLAIMANT-APPELLANT

DOCKET ENTRIES

DATE	PROCEEDINGS
5/24/99	DOCKETED CAUSE AND ENTERED APPEARANCES OF COUNSEL. CADS SENT (Y/N): NO Setting schedule as follows: appellant's designation of RT is due 5/17/99; appellee's designation of RT is due 5/27/99; appellant shall order transcript by 6/7/99; court reporter shall file transcript in DC by 7/7/99; certificate of record shall be filed by 7/14/99; appellant's opening brief is due 8/23/99; appellees' brief is due 9/22/99; appellants' reply brief is due 10/6/99; [99-16021] (sm)

DATE	PROCEEDINGS
5/24/99	Filed Gary R. Allen for Appellant USA Civil Appeals Docketing Statement served on 5/7/99 (to CONFATT) [99-16021] [99-16021] (sm)
6/7/99	Rec'd ntc of appearance of Jeffrey R. Meyer as csl for USA; served on 6/3/99. [99-16021] (jr)
6/23/99	Case rejected from Circuit Mediation Program. (ah)
8/26/99	Filed original and 15 copies aplt's opening brf (Informal: no) of 44 pages and five excerpts of record in 1 volume; served on 8/23/99. [99-16021] (jr)
9/23/99	Filed original and 15 copies aple's 41 page brf; served on 9/22/99. [99-16021] (jr)
10/1/99	Rec'd Amicus Nat'l Restaurant's brf in 15 copies of 27 pages; served on 9/29/99 to (PRO MO w/motion to file).[99-16021] (jr)
10/6/99	Filed motion of Nat'l Restaurant Assoc's for leave to file brf as amicus curiae and deputy clerk order (Deputy Clerk: tah/PRO MO) the motion and any future related filings shall be referred for disposition to the panel that considers

DATE	PROCEEDINGS
	the merits of the case. [3766833-1] Copies of the proffered brf shall be provided to the panel to aid resolution of the motion. Any further request to file friend of the court brfs shall be treated in the same fashion. Aplt shall monitor the issuance of the cor. (Motion recvd 10/1/99) [99-16021] (jr)
10/7/99	14 day oral extension by phone of time to file['s] reply brief. [99-16021] appellants' reply brief due 10/25/99; (king)
10/18/99	Filed certificate of record or appeal RT filed in DC N/T [99-16021] (cha)
10/29/99	Filed original and 15 copies aplt's rpy brf (Informal: no) of 27 pages; served on 10/26/99. [99-16021] (jr)
12/27/99	Calendar check performed [99-16021] (rei)
1/13/00	Calendar materials being prepared. [99-16021] [99-16021] (aw)
1/20/00	CALENDARED: SAN FRAN Mar. 15 2000 9:00 am Courtroom 3 * * 1:30 pm BERKELEY Boalt Hall ** [99-16021] (aw)

DATE	PROCEEDINGS
2/23/00	Filed order (Deputy Clerk: gb) Nat'l Restaurant Assoc's motion to file an amicus curiae brf is GRANTED. [3766833-1] [99-16021] (jr)
2/23/00	Filed original and 15 copies Nat'l Restaurant's amicus brf of 27 pages; served on 9/29/99. [99-16021] (jr)
2/28/00	Rec'd USA's addl authority; served on 2/23/00 to (PANEL). [99-16021] (jr)
3/9/00	Rec'd aple's ltr of addl citations; served on 3/8/00 (FED EXED TO PANEL). [99-16021] (jr)
3/15/00	ARGUED AND SUBMITTED TO Alex KOZINSKI, Andrew J. KLEINFELD, M. M. MCKEOWN. [99-16021] (dl)
3/22/00	Rec'd aple's ltr dated 3/21/00 re: inquiries brought up during oral argument to (PANEL). [99-16021] (jr)
4/11/00	Received Jeffrey R. Meyer for Appellant USA letter dated 04/04/00 re: in response to appellees' letter dated 03/21/00 (PANEL) [99-16021] (sm)
5/8/00	Rec'd aplt's ltr dated 5/2/00 as addendum to ltr dated 3/21/00; served on 5/2/00 to PANEL). [99-16021] (jr)

DATE	PROCEEDINGS
6/26/00	Rec'd USA's ltr of addl authority; served on 6/21/00 to (PANEL). [99-16021] (jr)
3/7/01	FILED OPINION: AFFIRMED (Terminated on the Merits after Oral Hearing; Affirmed, Written, Signed, Published. Alex KOZINSKI, author; Andrew J. KLEINFELD; M. M. MCKEOWN, dissenting) FILED AND ENTERED JUDGMENT. [99-16021] (jr)
4/23/01	[4150207] Filed original and 50 copies aplt's petition for rehearing with suggestion for rehearing en banc 18 pages; served on 4/20/01 to (PANEL & ALL ACTIVE JUDGES). [99-16021] (jr)
5/18/01	Filed order (Alex KOZINSKI, Andrew J. KLEINFELD & M.M. MCKEOWN) the petition for rehearing is denied. [4150207-1] [99-16021] (jr)
5/30/01	MANDATE ISSUED [99-16021] (jr)
8/6/01	Rec'd ltr from the Supreme Court dated 8/3/01 re: extension granted to and including 9/15/01 in which to file cert petition. [99-16021] (jr)
9/27/01	Rec'd ntc from Supreme Court; petition for certiorari filed. Supreme Court No. 01-463; filed on 9/14/01 & placed on dkt 9/17/01. [99-16021] (jr)

DATE	PROCEEDINGS
1/22/02	Rec'd ltr from the Supreme Court dated 1/11/02 re: order entered 1/11/02 granting petition for writ of certiorari. Petitioner's brf is to be filed and served on or before 3 p.m. 2/25/02. Respondent's brf to be filed with the clk on or before 3 p.m. 3/27/02. Rpy brf, if any, to be filed with the clk on or before 4/15/02. Rule 29.2 is suspened. [99-16021] (jr)

TAB C

[Names Omitted]

UNITED STATES DISTRICT COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

CIVIL ACTION NO. C-97-4613

FIOR D'ITALIA, INC., PLAINTIFF

v.

THE UNITED STATES OF AMERICA, DEFENDANT

[Filed: Dec. 18, 1997]

COMPLAINT FOR REFUND OF TAXES PAID AND ABATEMENT OF TAXES ASSESSED

Plaintiff, Fior d'italia, Inc, by its attorneys, for its complaint alleges as follows:

1. Plaintiff is a corporation duly incorporated in the state of California with its principal place of business at 601 Union Street, San Francisco, California 94133.

2. Defendant is the United States of America.

3. This Court has jurisdiction over the subject matter of this complaint pursuant to the following statutory provisions:

(a) 28 U.S.C. 1331 (Judicial Code, federal question jurisdiction);

(b) 28 U.S.C. 1340 (Judicial Code jurisdiction concerning internal revenue laws);

(c) 28 U.S.C. 1346(a)(1) (Judicial Code jurisdiction concerning the recovery of erroneously or illegally assessed or collected internal revenue taxes); and

(d) 26 U.S.C. 7422 (Internal Revenue Code jurisdiction for civil action for refund).

Venue is predicted upon 28 U.S.C. 1391(e)(1992) and on 28 U.S.C. 1402(a)(2)(1982).

4. Plaintiff brings this action for the recovery of Federal Insurance Contribution Act (hereinafter "FICA") taxes illegally and erroneously assessed against and collected from Plaintiff on unreported tips of Plaintiff's employees in the aggregate as estimated by the Internal Revenue Service (hereinafter "IRS") for the years 1991 and 1992, under color of the Internal Revenue Law of the United States, specifically 26 U.S.C. 3121(q).

5. Plaintiff is primarily engaged in the business of preparing, processing and/or serving foodstuffs for immediate sale and consumption by the consumer on the premises through its restaurant operation. The restaurant is a large food and beverage establishment within the meaning of the Internal Revenue Code (hereinafter "IRC") § 6053(c) and the regulations thereunder, employs more than 10 employees on a typical business day, and tipping is customary within the restaurant.

6. Plaintiff receives, records, withholds, and pays the employer share of FICA taxes on the basis of all tips reported by employees in accordance with the law,

IRC §§ 3102, 3111, 3401, 6051, and 6053. In addition, Plaintiff timely files Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on an annual basis.

7. By letter dated December 19, 1994, IRS served Notice and Demand on Taxpayer employer for employer taxes on under reported tips as determined by IRS, purportedly pursuant to IRC Section 3121(q).

8. The amount of the assessment for the employer's share of unpaid FICA taxes on unreported tips was computed almost entirely on the basis of information filed by Plaintiff on Form 8027, using what is referred to by IRS as the "McQuatters Formula", which is derived from the case of *McQuatters v. Commissioner*, 32 CCH Tax Ct. Mem. 1122, 42 P-H Tax Ct. Mem. 1078 (1973).

9. Under the "MaQuatters Forluma," as utilized here, the charge tip rate was first determined on the basis of the total charged tips and charged sales reported on the Form 8027. This rate was then multiplied by the gross receipts as set forth on Form 8027 to determine the aggregate amount of tips received. Unreported tips are then determined by subtracting reported tips from the total tips estimated to have been received. The alleged unreported tips are then subjected to the FICA tax rate of 7.65% to determine the employer's FICA tax adjustment.

10. IRS determined, using this method, that Plaintiff owed additional unpaid FICA taxes of $11,976.00, on unreported tips allegedly received in 1991 and additional un paid FICA taxes of $11,286.00 on unreported tips allegedly received in 1992. IRS served Notice and Demand for these amounts by letter dated December

19, 1994, with a request that the amount be included on line 9 of the current quarter Form 941 filing due on January 31, 1995.

11. There was no attempt to apportion the taxes assessed among tipped employees, nor to credit the earnings of such employees with such tip income. Rather, the assessment was made on an aggregate basis against the gross earning of the restaurant, as shown in the attachments to the Notice and Demand letters, with instruction to pay the amount assessment in lump sum as an addition to taxes computed by the employer for the Form 941 due January 31, 1995.

12. In the case of an assessment for employer FICA taxes on aggregate unreported tips of all employees collectively without a determination of individual earnings it is impossible for individual W-2Cs reflecting the additional amount of tip earnings to be prepared by the employer. Since the Social Security Administration (SSA) uses such documents exclusively for purposes of crediting individual employees' wage earning history, no wage earnings history can ever be credit for such employees *even though the employees have honestly reported and paid their share of FICA taxes on such amounts.*

13. IRS's aggregate collection method results in a denial of social security earnings histories and corresponding social security benefits for those identified employees who actually *do* report the additional tip income to IRS and *do* pay the employee share of FICA Taxes on tips which they have not reported to their employer. If an employee declares the tip income on his income tax return and pays the resulting FICA taxes on such declared income, SSA will not credit that unreported tip income to that employee's earning

history until both employer and employee shares of FICA taxes on such unreported tips have been collected.

14. Plaintiff did not pay nor include the full amount of the taxes assessment on the December 31, 1994 Form 941 due January 31, 1995. Rather, Plaintiff included $18.36 on line 9 of the December 30, 1994 Form 941 due January 31, 1995 representing a partial payment under protest of the entire amount assessed for employer share of FICA taxes on under reported tips as provided for by *Flora* v. *United States*, 362 U.S. 145 (1960) and *Steele* v. *United States*, 280 F.2d 89 (8th Cir., 1960). The amount paid represents Plaintiff's calculation of the portion of the IRS assessment attributable to the imposition of employer share of FICA taxes under circumstances where clearly no FICA taxes would be due; to wit, where tip income is exempt from the definition of wages subject to the tax under I.R.C. § 3121(a)(12), where individual employees have reported well in excess of the average tip rate for the unit as determined by IRS using the "McQuatters Formula," and where tips were paid over to indirectly tipped employees, since there is no rational basis for using factors approved by the court in the *McQuatters* case, or any other case, to estimate tip income paid to indirectly tipped employees.

15. On February 20, 1995, Plaintiff filed a claim for a refund of the $18.36 partial payment made by the Plaintiff and an abatement of the full amount of the taxes, $23,262.00, assessed pursuant to the December 19, 1994 Notice and Demand. (See Form 843 with accompanying statement, attached hereto, as Exhibit A, and made apart hereof).

16. This suit for recovery of said amounts collected and assessed is brought on the same grounds or reasons as those set out in said claim for refund attached as Exhibit A.

17. The taxes wrongfully assessed and exacted from Plaintiff are predicated on the contention by the Commissioner of Internal Revenue and his representatives that § 3121(q) provides the Internal Revenue Service with the authority to assess FICA taxes against an *employer only* without any determination that the individual reports by employees pursuant to § 6053(a) were inaccurate or incomplete and without any attempt to credit the earnings of employees for Social Security benefits purposes with the additional tip income serving as the basis of the assessment against the employer. IRS further contends that IRC § 446 provides it with the authority to adjust the *employer's* FICA returns because the *employee* tip reports upon which the employer is statutorily permitted to rely may be inaccurate. IRS also apparently believes that such adjustment may be calculated on an aggregate rather than an individual employee-by-employee basis, using the "McQuatters Formula" case.

18. The collection and assessment of the FICA taxes herein described is illegal and erroneous for a number of reasons, but primarily because:

(a) Assessment of an employer share of FICA taxes on unreported tips with no Social Security benefit to the employees if such employer who allegedly received the tips is clearly contrary to the express Congressional purpose of the Social Security Act to provide old age and disability benefits based upon earnings credited for benefit purposes,

specifically contrary to the legislative purpose of Section 3121(q) to subject employers to tax on all tips which are credited for benefit purposes; and, in the requirement that only one type of employer pay an exaction for which its employees have no possibility of receiving intended benefits, is a violation of the Due Process, Equal Protection, and Just Compensation guarantees of the Fifth Amendment of United States Constitution;

(b) The "McQuatters Formula" is inappropriate as applied solely to the employer share of FICA taxes on estimated unreported tips in the absence of evidence that individual reports by employees were inaccurate or non-existent; and

(c) IRS's assessment based upon an average tip rate, calculated using the "McQuatters Formula" and applied across the board to all employees of a restaurant unit, effectively imposes a tax in circumstances where no tax would be due, e.g. where individual employee annual income exceed the maximum amounts upon which employment taxes are due; the tipped income of an individual employee was less than $20.00 for any one month; or the amount of tipped income retained by an individual employee was less than the average tip rate as calculated by IRS.

19. Neither the Secretary of Treasury nor his delegate, the District Director of Internal Revenue, has rendered a decision on said claim for refund. The statutory period of six months from the date of the filing of the claim for refund here involved, during which the Plaintiff is prohibited from bringing any suit or proceeding for the recovery of the taxes and

liabilities herein sought to be refunded, has expired and Plaintiff may now properly bring this suit (IRC § 6532(a)(1)).

WHEREFORE, Plaintiff, Fior d'Italia, Inc. demands judgement against Defendant in the amount of $18.36 plus interest thereon from January 31, 1995 to present; judgment ordering Defendant to abate any and all taxes assessed pursuant to 26 U.S.C. 6404 (1988); and, such further relief to which Plaintiff may be entitled, including but not limited to any costs and fees as provided under 26 U.S.C. 7430, together with any other costs and interest as provided by law.

Respectfully Submitted,

RICHARD L. DAVIS
Co-Counsel for Plaintiff

Dated: December 17, 1997 /s/ RICHARD L. DAVIS,

RICHARD L. DAVIS
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Co-Counsel: Thomas W. Power
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TAB D

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA,
DEFENDANT AND COUNTERCLAIMANT

v.

FIOR D'ITALIA, INC., COUNTERCLAIM DEFENDANT

[Filed: Apr. 28, 1998]

ANSWER AND COUNTERCLAIM OF THE UNITED STATES

COMES NOW the defendant **United States of America** by and through its counsel of record, Michael J. Yamaguchi, United Stated Attorney for the Northern District of California, Jay R. Weill, Assistant United States Attorney, Chief, Tax Division, and Thomas Moore, Assistant United States Attorney, Tax Division, and for its answer to plaintiff's complaint, admits, denies and alleges as follows:

Denies each and every allegation of such complaint not admitted, qualified or otherwise specifically referred to below:

Furthering answering, the defendant United States of America says that:

1. Admits the allegations contained in paragraph 1 of the complaint.

2. Admits the allegations contained in paragraph 2 of the complaint.

3. Admits the allegations contained in paragraph 3 of the complaint.

4. Admits the allegations contained in paragraph 4 of the complaint, except denies taxes were illegally assessed or collected.

5. Admits the allegations contained in paragraph 5 of the complaint.

6. Denies the allegations contained in paragraph 6 of the complaint for lack of knowledge or information to sufficient to form a belief as to the truth of the allegations contained therein.

7. Admits the allegations contained in paragraph 7 of the complaint.

8. Denies the allegations contained in paragraph 8 of the complaint.

9. Admits the allegations contained in paragraph 9 of the complaint.

10. Admits the allegations contained in paragraph 10 of the complaint.

11. Denies the allegations contained in the first sentence of paragraph 11 of the complaint for lack of knowledge or information to sufficient to form a belief as to the truth of the allegations contained therein. Denies the allegations contained in the second sentence of the complaint.

12. To the extent Rule 8 requires a response to allegations contained in paragraph 12, the United States denies such allegations.

13. To the extent Rule 8 requires a response to allegations contained in paragraph 13, the United States denies such allegations.

14. Denies the allegations contained in paragraph 14 of the complaint for lack of knowledge or information to sufficient to form a belief as to the truth of the allegations contained therein.

15. Admits the allegations contained in paragraph 15 of the complaint.

16. Admits the allegations contained in paragraph 16 of the complaint.

17. To the extent Rule 8 requires a response to allegations contained in paragraph 17, the United States denies such allegations.

18. To the extent Rule 8 requires a response to allegations contained in paragraph 18, the United States denies such allegations.

19. Denies the allegations contained in paragraph 19 of the complaint for lack of knowledge or information to sufficient to form a belief as to the truth of the allegations contained therein. Continuing, defendant United States of America for is

COUNTERCLAIM AGAINST PLAINTIFF FIOR D'ITALIA

alleges as follows:

20. This counterclaim is made against Fior d'Italia, Inc., as a counterclaim defendant, pursuant to Rule 13 of the Federal Rules of Civil Procedure, to reduce to

judgment and collect from Fior d'Italia assessed but unpaid internal revenue taxes, penalties and interest owed to the counterclaim plaintiff United States for which counterclaim defendant Fior d'Italia is liable under Section 3121(q) of the Internal Revenue Code.

21. This counterclaim is directed by the Attorney General of the United States of America and is authorized by the Secretary of the Treasury or his delegate pursuant to 26 U.S.C. § 7401.

22. Jurisdiction of this counterclaim is conferred on the Court by Sections 1340 and 1345 of Title 28, United States Code, and Section 7402 of the Internal Revenue Code (26 U.S.C.).

23. The liability for the internal revenue taxes accrued within the Northern District of California.

24. On April 15, 1998, a delegate of the Secretary of the Treasury made an assessment in the amount of $23,262 against taxpayer Fior d'Italia for unpaid 1991-1992 Form 941 taxes, $2,324.00 for penalties and interest of $7,839.57.

25. Despite timely notice and demand for payment of the assessment described in paragraph 24 above, defendant Fior d'Italia has neglected, failed, or refused to pay the assessment described in paragraph 24 above, and there remains due and owing on said assessment, as of April 27, 1998, the sum of $33,425.87, plus accrued interest and penalties and other statutory additions as provided by law, minus any payments or credits.

WHEREFORE, having fully answered each and every allegation contained in plaintiff's complaint and upon its allegations set forth in its counterclaims against

plaintiff, Fior d'Italia, defendant United States of America prays:

(A) Plaintiff take nothing by its complaint;

(B) That judgment be entered in favor of the United States against Fior d'Italia in the amount of $33,425.57, plus interest and other additions from the date of assessment as provided by law, less any payments and abatements; and

(C) The United States of America be awarded its cost of suit.

(D) That the Court award such other relief as is just and proper.

MICHAEL J. YAMAGUCHI
United States Attorney

/s/ ILLEGIBLE
THOMAS MOORE
Assistant United States
Attorney
Tax Division

TAB E

* * * * *

[4]

reported tips as provided for by *Flora v. United States*, 362 U.S. 145 (1960) and *Steele v. United States*, 280 F.2d 89 (8th Cir., 1960).

For purpose of this litigation alone, Taxpayer does not dispute the facts, estimates and/or determinations used by IRS as a basis for its calculation of an amount of aggregate unreported tip income by all directly and indirectly tipped employees of the taxpayer collectively.

Whether or not one or more dollars of aggregate tip income was unreported by Taxpayer's employees collectively and the reasonableness of the estimate of that amount of aggregate tip income unreported by all the employer's employees collectively, is irrelevant to the question presented in this case however.

The only facts relevant to the Court's disposition of this Motion are:

1) That IRS made an assessment for employer share only FICA taxes on the basis of estimated aggregate unreported tip income of Taxpayer's employees collectively;

2) That there was no attempt to (or mechanism to) credit the Social Security Administration earnings record of individual employees with such additional tip income, and,

3) That the assessment against the employer was not based upon the determination of the amount of additional tip income earned by individual employees.

With respect to these material facts there is no genuine dispute and Taxpayer is entitled to Judgment as Matter of Law[2].

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[2] Federal Rules Civil Procedure 56, *Celotex Corp. v. Catrett*, 477 U.S. 317, 106 S. Ct. 2548 (1986). *First National Life Insurance Co. v. California Pacific Life Insurance Co.*, 876 F.2d 877 (11th Cir. 1989).

TAB F

Form **8027**

Department of the Treasury
Internal Revenue Service

Employer's Annual Information Return of Tip Income and Allocated Tips

OMB No. 1545-0714

1991

Use IRS label. Make any necessary changes. Otherwise, please type or print.

Name of establishment

Address (number and street)

City or town, state, and ZIP code

94-2420391
Employer identification number

Kind of establishment (check only one box)

- ☐ 1 evening meals only
- ☒ 2 evening and other meals
- ☐ 3 meals other than evening meals
- ☐ 4 alcoholic beverages

Employer's name
Fior d' Italia, Inc

Establishment number (See instructions.)

Address (number, street, and room or suite no.)
601 Union St., S

City or town, state, and ZIP code
San Francisco, CA. 94133

If this is a Final Return, check here . . . . . ▶ ☑ If this is an Amended Return, check here . . . . . ▶ ☐

1	Total charged tips for 1991. . . . . Computer Tip Report	1	364,786
2	Total charged receipts (other than nonallocable receipts) showing charged tips . . . . Sales Journals	2	2,518,147
3	Total amount of service charges of less than 10% paid as wages to employees	3	0
4a	Total tips reported by indirectly tipped employees . . . . . Tip Report	4a	30,977
b	Total tips reported by directly tipped employees	4b	216,204
c	Total tips reported (Add lines 4a and 4b.) . . . . . Form 941	4c	247,181
5	Gross receipts from food or beverage operations (other than nonallocable receipts). . . 1-2-3 P+L	5	2,786,239
6	Multiply line 5 by 8% (.08) or the lower rate shown here ▶ _____ granted by the district director	6	222,899
	Note: *If you have allocated tips using other than the calendar year (semimonthly, biweekly, quarterly, etc.), put an X on line 6 and enter the amount of allocated tips from your records on line 7. If you have been granted a rate lower than 8%, attach a copy of the district director's determination letter to this return.*		
7	Allocation of tips. If line 6 is more than line 4c, enter the difference here	7	N/a
	This amount must be allocated as tips to tipped employees working in this establishment. Check the box below that shows the method used for the allocation. (Show the portion, if any, attributable to each employee in box 7 of the employee's Form W-2.)		
a	Allocation based on hours-worked method (See instructions for restriction.) . . . ☐		
b	Allocation based on gross receipts method . . . . . ☐		
c	Allocation based on good faith agreement (Attach copy of agreement.) . . . . ☐		
8	Total number of directly tipped employees at this establishment during 1991 . . . . . W-2's 18		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Rudy A Andreini Title ▶ Bookkeeper Date ▶ 2/27/92

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 49989U Form **8027** (1991)

☆ U.S. GPO: 1991-285-586

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Form **8027**

Department of the Treasury
Internal Revenue Service

...ployer's Annual Information Return of Tip Income and Allocated Tips

OMB No. 1545-0714

1992

Use IRS label. Make any necessary changes. Otherwise, please type or print.

Name of establishment

Address (number and street)

94-2420391
Employer identification number

City or town, state, and ZIP code

Kind of establishment (check only one box)

- ☐ 1 evening meals only
- ☒ 2 evening and other meals
- ☐ 3 meals other than evening meals
- ☐ 4 alcoholic beverages

Establishment number (See instructions.)

Employer's name: Fior d' Italia, Inc.

Address (number, street, and room or suite no.): 601 Union St.

City or town, state, and ZIP code: San Francisco, CA. 94133

If this is a Final Return, check here . . . . . ▶ ☐ If this is an Amended Return, check here . . . . . ▶ ☐

1	Total charged tips for 1992 . . . . . monthly Resman cash Accum.	1	338,161
2	Total charged receipts (other than nonallocable receipts) showing charged tips . . . . Sales Journal	2	2,366,757
3	Total amount of service charges of less than 10% paid as wages to employees	3	~~0~~
4a	Total tips reported by indirectly tipped employees . . . . Payroll Reg. YTD	4a	19,155
b	Total tips reported by directly tipped employees	4b	201,690
c	Total tips reported (Add lines 4a and 4b.) . . . . Form 941	4c	220,845
5	Gross receipts from food or beverage operations (other than nonallocable receipts) . . . 1-22 P+L	5	2,677,842
6	Multiply line 5 by 8% (.08) or the lower rate shown here ▶ _____ granted by the district director	6	206,227
	Note: *If you have allocated tips using other than the calendar year (semimonthly, biweekly, quarterly, etc.), put an X on line 6 and enter the amount of allocated tips from your records on line 7. If you have been granted a rate lower than 8%, attach a copy of the district director's determination letter to this return.*		
7	Allocation of tips. If line 6 is more than line 4c, enter the difference here	7	n/a
	This amount must be allocated as tips to tipped employees working in this establishment. Check the box below that shows the method used for the allocation. (Show the portion, if any, attributable to each employee in box 7 of the employee's Form W-2.)		
a	Allocation based on hours-worked method (See instructions for restriction.) . . . ☐		
b	Allocation based on gross receipts method . . . . . ☐		
c	Allocation based on good faith agreement (Attach copy of agreement.) . . . . . ☐		
8	Total number of directly tipped employees at this establishment during 1992 ▶ 19 W-2		

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Judy Audiero Title ▶ Office Mgr. Date ▶ 8/26/93

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 49999U Form **8027** (1992)

*U.S. GPO: 1992-343-034/60148

TAB G

Internal Revenue Service Department of the Treasury

District Director

1301 Clay Street
Oakland, CA 94612-5210

Fior D Italia Inc. 9549
601 Union Street
San Francisco, CA 94133

Person to Contact:
Gina Fresquez
Telephone Number:
(510) 637-2623

Refer Reply to:
94-2420391

Date: [Dec. 19,XX]

Dear Taxpayer:

This letter serves as your notice and demand as outlined in IRC section 3121(q) for the payment of the employer's IRC section 3111 FICA tax on unreported tips received by your employees in the amount of $23,262 on $304,074 of unreported tips from cash and charge sales from the periods 1991 and 1992.

This tax should be reported as an adjustment to FICA taxes on the employer's Form 941 for the calendar quarter in which this notice and demand is made.

A copy of this notice and demand must be attached to the return.

To avoid any possible deposit penalty, the tax must be deposited at an authorized bank, using Form 8190B, (Federal Tax Deposit Coupon) within your prescribed depository rules. If you have a payroll service depositing your payroll taxes, they should be notified of this notice immediately.

If you have any questions, please call the number listed above.

Sincerely,

/s/ JOE BENTAN
For Calvin E. Esselstrom
District Director

TAB H

Internal Revenue Service
District Director

Date: [SEP 17, 1996]

Person to Contact:
T. Laux
Contact Telephone Number:
(415) 522-6228

Tracey J. Power
POWER & COLEMAN
2300 Clarendon Blvd. #1107
Arlington, VA 22201

Dear Authorized Representative:

The enclosed material is furnished to you under the provisions of a power of attorney or other authorization you have on file with us. For your convenience we have listed below the name(s) of the taxpayer(s) to whom this material relates.

If you have any questions, please contact the person whose name and telephone number are shown above.

Sincerely,

/s/ ROBERT D. AH NEE
ROBERT D. AH NEE
District Director

Enclosures:
Letters
Reports
Taxpayer(s)' Name(s)

FIOR D'ITALIA, INC.
601 Union Street
San Francisco, Ca

Internal Revenue Service
District Director

Letter 950
Taxpayer Identifying Number:
94-2 0391
Form: 941
Person to Contact:
T. Laux
Telephone Number:
(415) 522-6228

FIOR D'ITALIA, INC.
601 Union Street
San Francisco, Ca

Tax Year Ended: December 31, 1994

Deficiency:
Increase in tax $ 23,262
Penalties
IRC 6656 (a) $ 2,324

Dear Taxpayer:

We are enclosing a report proposing adjustments to your tax for the year(s) shown above. Please read the report, decide whether you agree or disagree, and respond within 30 days from the date of this letter. [Our report may not reflect results of examinations of flow-through entities such as partnerships, S corporations, trust in which you may have an interest.]

IF YOU AGREE, you should:

1. Sign and date the enclosed agreement form.
2. Return the signed agreement form in the enclosed envelope.

3. Enclose payment of the tax and interest if additional tax is due. This will stop the compounding of interest. The person whose name and telephone number appear above will be able to tell you how much interest is due at the time you intend to make payment. (See the enclosed Publication 5 for additional payment information.)

After we receive your signed agreement form, we will process your case and bill you for any unpaid tax or interest, subject to acceptance by the district director.

IF YOU DO NOT AGREE and wish a conference with the Office of the Regional Director of Appeals, you MUST LET US KNOW within 30 days.

1. If the proposed change to your tax (including penalties) is $2,500 OR LESS, call the person whose name and telephone number appear above. He or she will arrange for your case to be forwarded to the office of appeals. Or, check the appropriate section at the end of this letter. An additional copy of this letter is provided for this purpose. Mail it in the enclosed envelope.
2. If the proposed change to your tax (including penalties) is more than $2,500 but $10,000 or less for any tax period, you must provide us with a BRIEF written statement of the disputed issues. An additional copy of this letter is provided for this purpose. Mail it to us the enclosed envelope.
3. If the proposed change to your tax (including penalties) is MORE THAN $10,000 for any tax period, we will require a written protest. Follow

the instructions in the enclosed Publication 5. Mail the protest to us in the enclosed envelope.

An appeals officer, who has not examined your return previously, will review your case. The appeals office is independent of the district director and resolves most disputes informally and promptly.

By going to the appeals office, you may avoid court costs, resolve the matter sooner, and prevent interest from compounding. An appeals officer will telephone you and arrange an appointment, if necessary.

If you do not reach an agreement with the appeals office or respond to this letter, we will process your case on the basis of the enclosed examination report. If you decide to bypass the appeals process and petition the tax court, normally your case will be assigned for settlement to an appeals office before the tax court hears the case. Also, you should be aware that the tax court does not have jurisdiction over excise or employment tax cases.

Please note too that under section 6673 of the Internal Revenue Code, the tax court can impose a penalty of up to $25,000 under certain conditions. These conditions include: if the court finds that the taxpayer instituted the proceedings primarily for delay; if the taxpayer's position is found to be frivolous or groundless; or if the taxpayer failed to pursue administrative remedies available.

IF YOU ARE UNSURE as to what to do or if you have other questions, call the person whose name and telephone number appear above. He or she will be glad to discuss your choices.

Sincerely,

/s/ ROBERT D. AH NEE
ROBERT D. AH NEE
District Director

Enclosures:
Copy of this letter
Examination Report
Agreement Form
Publications 5 and 594
Envelope

STATEMENT OF DISPUTED ISSUES

FIOR D'ITALIA, INC.	TIN: 94-2420391 REF: EG: 1368

Check appropriate block:

[ ] TAX (including penalties) IN DISPUTE IS $2,500 OR LESS FOR ANY TAX PERIOD (Note: You may call us with this request if you prefer.)

I disagree and wish a conference with an appeals officer.

_____

Signature Date

[ ] TAX (including penalties) IN DISPUTE IS OVER $2,500 BUT IS $10,000 OR LESS FOR ANY TAX PERIOD

Unagreed Adjustment(s): Reason for Disagreement:

(If more space is needed, attach a separate sheet.)

_____

Signature Date

EXPLANATION OF ADJUSTMENTS

NAME: FIOR D'ITALIA, INC. FORM 941
EIN : 94-2420391 DECEMBER 31, 1994

TAXPAYER POSITION:
FORM 8027. Employer's Annual Information Return of Tip Income and Allocated Tips for 1991 and 1992 were properly completed.

In response to the Notice and Demand, the taxpayer included $18.36 of employer's share of FICA taxes it believed to owe on Form 941 for the quarter ending December 31, 1994. The amount was determined based on $40.00 and $200.00 of unreported tips from a part-time employee in 1991 and 1992, respectively.

The representative on behalf of the taxpayer disagrees with the amount on the Notice and Demand and request for an abatement. The Internal Revenue Service have illegally applied the provisions of IRC 3121(q). The FICA tax determined is erroneous because it is based on the aggregate estimated unreported tips of all employees collectively rather than on the determination of the aggregate unreported tip income of individual employees. The tip adjustment to increase the employees earnings were not forwarded to the Social Security Administration so that each individual employee get credited for the additional earnings for the purpose of Social Security benefits. The adjustment of tax on the taxpayer is based on allegations of inacuracies another taxpayer's returns.

GOVERNMENT POSITION
The proposed adjustment is reasonably based on IRC Section 3121(q), therefore, the unreported tips subject

to FICA tax should be reported and paid on Form 941 for the quarter ending December 31, 1994.

CONCLUSION

Cash and charge tips received by the employees in the course of his/her employment are renumeration subject to employer's FICA tax. Employer's FICA tax of $23,262 for the unreported cash and charge tips for 1991 and 1992 are due.

EXPLANATION OF ADJUSTMENTS

NAME: FIOR D'ITALIA, INC. FORM 941
EIN : 94-2420391 DECEMBER 31, 1994

SOCIAL SECURITY TIPS INCOME ADJUSTMENT

	1991	1992	TOTAL
Per Return	$247,181	$220,845	
Per Exam	403,726	368,374	
Adjustments	$156,545	$147,529	$304,074

BACKGROUND

Fior D'Italia, Inc., the taxpayer, is located at 601 Union Street in San-Francisco, California. The taxpayer employed individuals to serve food and beverages. These employees received cash and credit card tips from customers. At the end of each shift, employees with credit card tips were reimbursed with cash by the taxpayer.

On December 19, 1994, a Notice and Demand was issued for the taxpayer's share of FICA tax in the amount of $23,262 on $304,074 of unreported cash and credit card tips for 1991 and 1992. See Exhibit A.

Of this $23,262 FICA tax, $18.36 was reported and paid by the taxpayer on Form 941 for the quarter ending December 31, 1994.

The taxpayer agrees with the sales and reported tips amount for 1991 and 1992.

LAW

IRC Section 3121(q)

Tips received by an employee in the course of his employment shall be considered renumeration for such employment. Such renumeration shall be deemed to be

paid (if no statement is furnished by the employee to the employer) at the time received or on the date on which notice an demand for such taxes is made to the employer by the Secretary (IRS Representative).

IRC Section 3111(a) and 3111(b) impose FICA tax on employer, rates are 6.2% and 1.45% on employees wages.

IRC Section 3401(a) defines wages.

IRC Section 3401(f) defines wages to include tips received by an employee in the course of his employment.

Interest on Deficiencies

Interest on deficiencies will accrue from the due date of the return until paid.

Failure To Make Deposit of Taxes IRC section 6656(a)

Since you did not deposit taxes within the time prescribed by law, and you have not shown that such failure was due to reasonable cause, a penalty of 40% of the amount of the underpayment is added to the tax in accordance with section 6656 of the Internal Revenue Code.

Instructions for Form 870

General Information

If you consent to the assessment of the deficiencies shown in this waiver, please sign and return the form in order to limit any interest charge and expedite the adjustment to your account. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are so entitled. It will not prevent us from later determining, if necessary, that you owe additional tax; nor extend the time provided by law for either action.

We have agreements with State tax agencies under which information about Federal tax, including increases or decrease, is exchanged with the States. If this change affects the amount of State income tax, you should file the required State form.

If you later file a claim and the Service disallows it, you may file suite for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

We will consider this waiver a valid claim for refund or credit of any overpayment due you resulting from any decrease in tax and penalties determined by the Internal Revenue Service, shown above, provided you sign and file it within the period established by law for making such a claim.

Who Must Sign

If you filed jointly, both you and your spouse must sign. If this waiver is for a corporation, it should be signed with the corporation name, followed by the signatures and titles of the corporate officers

authorized to sign. An attorney or agent may sign this waiver provided such action is specifically authorized by a power of attorney which, if not previously filed, must accompany this form.

If this waiver is signed by a person acting in a fiduciary capacity (for example, and executor, administrator, or a trustee) Form 56, Notice Concerning Fiduciary Relationship, should, unless previously filed, accompany this form.

EXHIBIT A

FIOR D' ITALIA, INC.

	1991	1992	TOTAL
Charge Tips (line 1, Form 8027)	364,786	338,161	
Charge Sales (line 2, Form 8027)	2,518,147	2,366,757	
Charge Tip Rate (line 1/line 2)	14.49%	14.29%	
Gross Receipts (Line 5, Form 8027)	2,786,239	2,577,842	
Total Tips Received (charge tip rate X gross receipts)	403,726	368,374	
Less: Total Tips Reported	247,181	220,845	
IRC 3121(q) (Adjustment)	156,545	147,529	$304,074
Employers FICA tax rate	7.65%	7.65%	
IRC 3121(q) tax	$11,976	$11,286	$23,262

Form 870	Department of the Treasury - Internal Revenue Service Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment	Date received by IRS

Names and address of taxpayers	Social security or employer identification number
FIOR D'ITALIA, INC. 601 Union Street San Francisco, Ca	94-2420391

Increase (Decrease) in Tax and Penalties

Tax Year Ended:	December 31, 1994
Deficiency:	
Increase in tax	$ 23,262
Penalties	
IRC 6656(a)	$ 2,324

(For instructions, see next page)

Consent to Assessment and Collection

I consent to the immediate assessment and collection of any deficiencies (increase in tax and penalties) and accept any overassessment (decrease in tax and penalties) shown above, plus any interest provided by law. I understand that by signing this waiver, I will not be able to contest these years in the United States Tax Court, unless additional deficiencies are determined for these years.

Your Signature	Date signed
Spouse's Signature	Date signed
Taxpayer's Representative Sign Here	Date signed
Corporate Name:	
Corporate Officers Sign Below	
Signature Title	Date signed
Signature Title	Date signed

Form 870 (Rev. 3-92)

BEST AVAILABLE COPY

EXPLANATION OF ADJUSTMENTS

NAME: FIOR D'ITALIA, INC. FORM 941
EIN : 94-2420391 DECEMBER 31, 1994

FAILURE TO DEPOSIT PENALTY: $2,324

FACTS

On December 19, 1994, a Notice and Demand was issued for the employer's FICA tax in the amount of $23,262 on $304,074 of unreported cash and charge card tips for 1991 and 1992.

Of this $23,262 FICA tax due, $18.36 was reported and paid by the taxpayer on Form 941 for the quarter ending December 31, 1994.

LAW

IRC Section 6656(a) Underpayment of Deposits states in the case of failure to deposit on the date prescribed, unless it is shown that such failure is due to reasonable cause and not due to willfull neglect, there shall be imposed a penalty of 10 percent on the amount of the underpayment of tax.

TAXPAYER POSITION

Failure to deposit penalty is disputed because employer's IRC 3111 FICA tax is disputed.

CONCLUSION

Since the deposit as required by law was not fully paid, Failure to Deposit Penalty is asserted.

Form 4668	Department of the Treasury -- Internal Revenue Service EMPLOYMENT TAX EXAMINATION CHANGES REPORT	Return form number 941

Name and address of employer	Employer identification number	Calendar year
FIOR D' ITALIA, INC. 601 Union Street San Francisco, CA 94133	94-2420391	1994
	Total tax plus penalty, or (decrease) in tax $25,586	Last quarter of this examination 12/31/94
Examination discussed with (name and title)	( ) Agreed (Subject to acceptance by the District Director) ( ) Unagreed	

	IRS Ref.	(a) Applicable Rate	(b) 1st Quarter	(c) 2nd Quarter	(d) 3rd Quarter	(e) 4th Quarter
1. Social security and Medicare wage adjustment subject to tax under IRC 3101 and 3111	004 073					
2. Social security and Medicare wage adjustment subject to tax under IRC 3509(a)	004 073					
3. Social security and Medicare wage adjustment subject to tax under IRC 3509(b)	004 073					
4. Social security and Medicare tip adjustment subject to tax under IRC ~~3201~~ and 3111(a) & (b)	005 073	6.20 1.45				$304,074 $304,074
5. Income tax withholding wage adjustment subject to tax under IRC 3402						
6. Income tax withholding wage adjustment subject to tax under IRC 3509						
7. Payments subject to backup withholding under IRC 3406						
8. Adjustment to social security and Medicare tax						
9. Adjustment to income tax withholding						
10. Total social security and Medicare tax (Lines 1,2,3,4 x rates) plus/minus Line 8	007					$ 23,262
11. Total income tax withholding (Lines 5,6 x rates) plus/minus Line 9	003					
12. Total backup withholding (Line 7 x rate)	008					
13. Delinquent tax or increase (decrease) in tax (Lines 9, 10 and 11)						
14. Penalty code section 6651						
15. Penalty code section 6656 Failure to Deposit						$ 2,324
16. Penalty code section						
17. Maximum tax available for abatement under IRC 3402(d)						none

23262
- 18.36
23243.64
x 10 %
$2324

Examiner's signature	Group No.	District	Date
T. Tiny	1368	San Francisco	

Seq #

[Names omitted]

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

CIVIL ACTION No. 97-4613 CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

AFFIDAVIT OF JAMES M. BRIL

STATE OF CALIFORNIA
COUNTY OF MARIN

I, James M. Bril of full age, being duly sworn according to law, upon oath depose and say:

1. I am and was an employee during the calendar years 1991 and 1992 of Fior d' Italia, Inc., Plaintiff in the above referenced action, and I make this affidavit in support of Plaintiff's Motion for Summary Judgement.

2. It is, and during 1991 and 1992 was, the practice of directly tipped employees in the restaurant owned and operated by the plaintiff to share or give approximately 25% of their total tips received, whether cash or charge, to other indirectly tipped employees who assisted in providing service to tipping customers. More specifically, it is and was the practice in the restaurant for each directly tipped employee to give approximately 15% to busboys, 5% to bartenders and

5% to host and hostess who seated customers. It is possible many directly tipped employees gave a higher or lower percentage of their total tips to certain employees depending on the disposition and generosity of the directly tipped employee and the directly tipped employee's evaluation of the contribution made by the specific indirectly tipped employee.

3. To the best of my knowledge and belief these tip splitting practices and the customary percentages set forth above are and were known to all employees of the restaurant.

4. I do not know and I do not believe any directly tipped employees obtained a receipt or receipts from employees with whom they shared a percentage of their tips.

Further, Affiant sayeth not.

/s/ JAMES M. BRIL
JAMES M. BRIL

Sworn to or subscribed before me
this 15 day of May, 1998

[Seal Omitted]

/s/ CARLA FRITZ
CARLA FRITZ
Notary Public

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 15th day of May 1998, a true and correct copy of the foregoing AFFIDAVIT OF JAMES M. BRL [*sic*] *was mailed first class, postage prepaid to the following counsel of record for the Defendant.*

Thomas Moore, Esquire
U.S. Attorney's Office
10th Floor Federal Building
450 Golden Gate Avenue, Box 36055
San Francisco, CA 94102

/s/ JAMES M. BRIL
JAMES M. BRIL

TAB I

[Names Omitted]

LEE, TOOMEY & KEN
CHARTERED
1800 EIGHTEENTH STREET, N.W.
WASHINGTON, D.C. 20036
TELEPHONE (202) 457-6500
FACSIMILE (202) 457-7660
(202) 457-0551
CABLE ADDRESS "LEETAK"

July 14, 1993

Via Telecopy

Norman Goldstein
Senior Financial Executive
6401 Security Boulevard
451 Altmeyer Building
Baltimore, Maryland 21235

Re: Establishment of FICA Wage Base from FICA Tax Paid (or Assessed) on Tips

Dear Norm:

Thanks for sending me the information from the IRS Publications on tip reporting. These materials do not give me the specific information I need, however, to understand precisely how a particular FICA tax payment is used by SSA to credit the employee's Social Security and Medicare accounts.

I have outlined below the precise questions I was hoping to have answered, either by the SSA Program Operations Manual, or by some other SSA guidance available either through the SSA "Bulletin Board: system or otherwise.

(1) Which of the following payments will be used by SSA to credit the employee's wage history?

(a) Payment by the employer of the employer's share of FICA taxes on reported tips?

(b) Collection and deposit by the employer of the employee's share of FICA taxes on reported tips (to the extent collectible from the employee's wages)?

(c) Payment by the employee (with the employee's Form 1040, Line 53) of the uncollected employee FICA taxes on reported tips (reported in Box 13, Codes A and B) of the 1993 Form W-2)?

(d) Payment by the employee of employee FICA taxes on unreported tip income, as shown on Schedule U of Form 4137?

> Note: The employee may report an amount of "unreported tips" on Form 4137 that differs from the "allocated tip" amount reported in Boxes 5 and 7 of the 1993 Form W-2.

(e) Filing by the IRS of Form 885-T (including Schedule T-A) reporting an audit adjustment of employee FICA tax on unreported tip income (which increases the amount of tip income reported by the employee on Form 4137)?

(f) Assessment and collection by the IRS of the additional employee FICA taxes reflected on Form 885-T?

(g) Issuance of a "Notice and Demand" to the employer for additional employer FICA

taxes under Code section 3121(q) (as amended, effective in 1988)?

(h) Collection from an employer of additional employer FICA taxes under Code section 3121(q) (as amended, effective in 1988)?

(2) Are answers to these questions outlined in (1)(a) through (h) above available in the SSA Program Operations Manual or in another SSA publication?

(3) It is possible to get a written answer from SSA to these questions, if no other SSA guidance has been published?

To summarize these questions, Norm, I'm trying to find some written explanations from SSA of whether, following the 1987 change to Code section 3121(q), SSA delays crediting the employee's social security and Medicare benefit accounts until after *both* the employee and employer shares of FICA taxes have been paid (or at least assessed) with respect to any tips that are determined (by the employer, employee or the IRS) to have been paid to the server. Second, if payment (or assessment) of the *employee* share of FICA taxes is all that is used by SSA to establish the requisite wage history credit, how can employers be sure that every employer payment of FICA taxes (see question (1)(a), (g) and (h) above) will result in the crediting of an employee's wage history?

Many thanks, Norm, for your help in finding me answers to these procedural problems.

Sincerely yours,

/s/ MARY B. HEVENER
Mary B. Hevener

[Seal Omitted]

DEPARTMENT OF HEALTH & HUMAN SERVICES

Social Security Administration

Refer to: Baltimore, MD 21235

Ms. Handy Hevener [JUL 20, 1993]
Lee, Toomey & Kent
1200 Eighteenth Street, N.W.
Washington, DC 20036

Dear Handy:

This letter responds to your questions relative to the establishment of a FICA wage base from FICA taxes paid on tips. SSA has not promulgated specific guidance concerning the issues you raised in your July 14, 1993 letter. In fact, SSA relies heavily on IRS' guidance to implement its own processes.

With respect to the questions you asked, I believe the answers can be found in the IRS guidance that I previously provided. Essentially, the amounts reported to SSA on Forms W-2 or W–2c constitute the basis on which SSA would credit an employees Social Security or Medicare accounts.

Under Section 3121(q) of the Internal Revenue Code, tips received by an employee in the course of the employees employment are considered remuneration for that employment (and are deemed to have been paid by the employer for purposes of the employer portion of FICA taxes imposed by Section 3111(a) and (b) of the Code)). The remuneration is deemed to be paid when a written statement(s) including the tips is furnished to the employer by the employee pursuant to Section 6053(a) of the Code.

Section 6053(a) of the Code requires every employee, who in the course of the employees employment by an employer, who receives in any calendar month tips that are wages (as defined in Section 3121(a) or 3401(a)) to report all tips in one or more written statements furnished to the employer on or before the 10th day of the following month. These procedures are reflected in IRS Publication 531 (Reporting Income From Tips).

Publication 531 discusses how employers are to withhold FICA for employees and report those amounts on Form W-2s. For each calendar month during which an employee receives $20 or more in tips, the employee must give the employer a written statement(s) of cash and charge tips by the 10th day of the month after the month in which the tips are received. IRS Form 4070, Employees Report of Tips to Employer, is available for this purpose. In situations where employees do not report monthly an appropriate amount of tips, and the employer has 10 or more employees, the employer is required to allocate tips. The employer would then withhold the appropriate amount of FICA and Medicare taxes from the employees salary and that amount is incorporated into the annual Form W-2 reporting process.

Tips totaling less than $20 received by an employee during a single calendar month while working for any one employer are not wages for FICA tax purposes and are, therefore not required to be reported to the employer. If an employee works for more than one employer during a month, and receives less than $20 in tips while working for each employer, no tips are required to be reported to any of the employers.

Although these tips are not subject to FICA taxes, they are subject to Federal income taxes.

If an employee fails to tips to his/her employer, the employer is not liable for its portion of the FICA taxes on unreported tips until "notice and demand" for the taxes is made to the employer by the Internal Revenue Service. This occurs when the employee completes IRS Form 4137, Social Security Tax on Unreported Tip Income, and files it with his/her Form 1040, (U.S. Individual Income Tax Return). Upon receipt of the Form 4137, IRS will issue a "notice and demand" to the employer for the amount of tips received by an employee (or employees) who failed to report or under reported tips to the employer. The employer will reflect payment of this liability as a Line 9 adjustment on the IRS Form 941, Employers Quarterly Federal Tax Return. The employer should provide an explanation of this adjustment on a Form 941c and submit to SSA a Form W-2c, Statement of Corrected Income and Tax Amounts, and Form W-3c, Transmittal of Corrected Income and Tax Statements.

In summary, SSA credits an employees Social Security and Medicare benefit accounts upon receipt of an appropriate Form W-2 or W-2c. The IRS instructions provide the circumstances, basis and the procedures by which these forms are to be filed with SSA. SSA does not concern itself with the actual collection of taxes per se and that is not a factor in crediting an individuals' earnings record. As previously indicated, SSA credits an earnings record as soon as information is provided by the employer as to the appropriate FICA and Medicare earnings as reflected on a Form W-2 or W-2c.

I hope the information above is helpful to you. If you should still have additional questions, it may be helpful to provide a specific example or situation that I can relate to in providing a more specific response. However, bear in mind that IRS writes the tax laws and instructional guidance relative to FICA and Medicare wages. SSA's focus is more on procedural guidance relative to physically reporting information contained on Form W-2s and W-2Cs.

Please call me if you have additional questions or I can provide you with any additional information concerning this matter.

Sincerely,

/s/ NORMAN GOLDSTEIN
NORMAN GOLDSTEIN

TAB J

[Names/Addresses Omitted]

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

[Filed: May 29, 1998]

DECLARATION OF THOMAS MOORE

I, THOMAS MOORE, declare:

1. I am employed as an Assistant United States Attorney with the United States Attorney's Office, in San Francisco, California.

2. In such capacity I have been assigned to represent the United States in the above captioned matter.

3. A true and correct copy of the Form 4340, Certificate of Assessments and Payments for Fior D'Italia is attached hereto as Exhibit 1.

4. True and correct copies of the plaintiff's Form 941 for the periods at issue are attached hereto as Exhibit 2.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on May 28th, 1998, San Francisco, California.

/s/ THOMAS MOORE
THOMAS MOORE

TAB K

UNITED STATES [Seal Omitted] OF AMERICA

Department of the Treasury

Internal Revenue Service

Date: May 27, 1998

CERTIFICATE OF OFFICIAL RECORD

I certify that the annexed: Certificate of Assessments and Payments, is true for Fior D'Italia, Incorporated 9549, 601 Union Street, San Francisco, California, Employer Identification Number: 94-2420391, covering Quarterly, Withholding and Federal Insurance Contribution Act Tax for the period ending December 31, 1994

under the custody of this office.

[Seal Omitted] **IN WITNESS WHEREOF, I have hereunto set my hand, and caused the seal of this office to be affixed, on the day and year first above written.**

By direction of the Secretary of the Treasury:

/s/ FRED ARRAS
FRED ARRAS
Chief, Accounting Branch

EXHIBIT 1

CERTIFICATE OF ASSESSMENTS AND PAYMENTS

EIN/SSN: 94-2420391

FIOR D'ITALIA, INC. 9549
601 UNION STREET
SAN FRANCISCO, CA

Date Rec'd	Explanation/ Locator Number	Assessments (Abatement)	Credits (Reversal)	Assessment Date
Type of Tax: QUARTERLY, WITHHOLDING & FICA TAX RETURN				
Period Ending: 12/31/94				
10/19/94	Federal tax deposit	0.00	11,906.47	
11/02/94	Federal tax deposit	0.00	12,127.98	
11/16/94	Federal tax deposit	0.00	10,720.74	
12/02/94	Federal tax deposit	0.00	10,703.75	
12/14/94	Federal tax deposit	0.00	8,880.16	
	Federal tax deposit	0.00	10,873.21	

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01/31/95	Return filed and tax assessed	65,230.65	0.00	03/27/95
02/01/95	Payment with return	0.00	18.34	
	Deposit penalty	1,369.46	0.00	07/10/95
07/10/95	First notice issued			
08/28/95	Deposit penalty abated	(1,369.46)	0.00	
	Audit deficiency tax assessed	23,262.00	0.00	04/27/98
	Deposit penalty	2,324.00	0.00	
	Interest	7,839.57	0.00	
04/27/98	First notice issued			

Continued on next page

CERTIFICATE OF ASSESSMENTS AND PAYMENTS

EIN/SSN: 94-2420391

FIOR D'ITALIA, INC. 9549
601 UNION STREET

Date Rec'd	Explanation/ Locator Number	Assessments (Abatement)	Credits (Reversal)	Assessment Date
(Continued: 12/31/94)				
	Account Balance:	$33,425.57		
	Accrued Interest:	309.08		06/08/98
	Accrued Penalty:	116.31		06/08/98
	Total Balance:	$33,850.96		
	Adjusted Gross Income:	NA.		
	Taxable Income:	NA.		

I certify that the foregoing transcript of the taxpayer named above in respect to the taxes specified, is a true and complete transcript for the period stated, of all assessments, penalties, interests, abatements, credits, refunds, and advance or unidentified payments relating thereto as disclosed by the records of this office as of the date of this certification.

Signature of Director, R Hon
(required for certification):

Location: IRS, Western Region
Fresno, CA

Chief, Accounting Branch

May 27, 1998
Date

TAB L

VBB/ /R /94/4/399 / 1

Form **941** (Rev. January 1994)
Department of the Treasury
Internal Revenue Service

4141

Employer's Quarterly Federal Tax Return

See separate instructions for information on completing this return.

Please type or print.

OMB No. 1545 0029

Enter state code for state in which deposits made (see page 2 of instructions).

Name (as distinguished from trade name)
FIOR D ILTALIA INC
Trade name, if any

Address (number and street)
601 UNION STREET

Date quarter ended
12/31/94
Employer identification number
94-2420391
City, state, and ZIP code
SAN FRANCISCO CA 94133

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If address is different from prior return, check here ▶ ☐

IRS Use

If you do not have to file returns in the future, check here ▶ ☐ and enter date final wages paid ▶

If you are a seasonal employer, see **Seasonal employers** on page 2 and check here (see instructions) ▶ ☐

1	Number of employees (except household) employed in the pay period that includes March 12th ▶			
2	Total wages and tips subject to withholding, plus other compensation		2	255679.94
3	Total income tax withheld from wages, tips, and sick pay		3	27506.92
4	Adjustment of withheld income tax for preceding quarters of calendar year		4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)		5	27506 92
6a	Taxable social security wages	$ 166882.44 × 12.4% (.124) =	6a	20693.42
b	Taxable social security tips	$ 77397.00 × 12.4% (.124) =	6b	9597.23
7	Taxable Medicare wages and tips	$ 255679.94 × 2.9% (.029) =	7	7414.72
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7). Check here if wages are not subject to social security and/or Medicare tax ▶ ☐		8	37705 37
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) Sick Pay $ _____ ± Fractions of Cents $ _____ ± Other $ _____ =		9	18 36
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions)		10	37723 73
11	Total taxes (add lines 5 and 10)		11	65230 65
12	Advance earned income credit (EIC) payments made to employees, if any		12	
13	Net taxes (subtract line 12 from line 11). This should equal line 17, column (d) below (or line D of Schedule B (Form 941))		13	65230 65
14	Total deposits for quarter, including overpayment applied from a prior quarter		14	65212 31
15	Balance due (subtract line 14 from line 13). Pay to Internal Revenue Service		15	18 34
16	Overpayment, if line 14 is more than line 13, enter excess here ▶ $ _____ and check if to be: ☐ Applied to next return OR ☐ Refunded.			

- **All filers:** If line 13 is less than $500, you need not complete line 17 or Schedule B. ☐
- **Semiweekly depositors:** Complete Schedule B and check here ☐
- **Monthly depositors:** Complete line 17, columns (a) through (d) and check here ☐

17 Monthly Summary of Federal Tax Liability.

(a) First month liability	(b) Second month liability	(c) Third month liability	(d) Total liability for quarter

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ _____ Print Your Name and Title ▶ Robert Lorick Pres. Date ▶ 1/30/95

For Paperwork Reduction Act Notice, see page 1 of separate instructions. Cat. No. 17001Z EXHIBIT Form 941 (Rev. 1-94).

1

Form **941**
(Rev. January 1991)
Department of the Treasury
Internal Revenue Service

4141

Employer's Quarterly Federal Tax Return

▶ See Circular E for more information concerning employment tax returns.

Please type or print.

OMB No. 1545-0029
Expires: 5-31-93

T
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T

Your name, address, employer identification number, and calendar quarter of return. (If not correct, please change.)

94-2420391 JUN91
FIOR D'ITALIA, INC.
601 UNION STREET
SAN FRANCISCO, CA 94133

AMENDED

C

(FOR YOUR RECORDS)

If address is different from prior return, check here ▶ ☐

If you do not have to file returns in the future, check here . . . ▶ ☐ Date final wages paid . . . ▶

If you are a seasonal employer, see Seasonal employers on page 2 and check here . ▶ ☐

1a	Number of employees (except household) employed in the pay period that includes March 12th . ▶	1a	
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) . . ▶ 1b –		
2	Total wages and tips subject to withholding, plus other compensation . . . . . ▶	2	263,610 30
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. . . ▶	3	25,121 81
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) . . ▶	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	25,121 81
6a	Taxable social security wages (Complete line 7) $ 199,689 30 × 12.4% (.124) =	6a	24,761 47
b	Taxable social security tips $ 63,921 00 × 12.4% (.124) =	6b	7,926 20
7	Taxable Medicare wages and tips $ 263,610 30 × 2.9% (.029) =	7	7,644 70
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	40,332 37
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) . . .	9	04 F/O
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ▶	10	40,332 41
11	Backup withholding (see instructions)	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year. . . . . ▶	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13)	14	65,454 22
15	Advance earned income credit (EIC) payments made to employees, if any . . . . . ▶	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	65,454 22
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records. ▶	17	65,454 22
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS . . . . ▶	18	
19	Overpayment, if line 17 is more than line 16, enter here ▶ $ _____ and check if to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
Check only if you made deposits using the 95% rule ▶ ☐ Check only if you are a first time 3-banking-day depositor. . . ▶ ☐

Do NOT Show Federal Tax Deposits Here

Date wages paid	Show tax liability here, not deposits. IRS gets deposit data from FTD coupons.					
	First month of quarter		Second month of quarter		Third month of quarter	
▶ 1st through 3rd	A		I	9,048.25	Q	
4th through 7th	B	8,917.31	J		R	
8th through 11th	C		K		S	
12th through 15th	D		L		T	8,414.32
16th through 19th	E	9,423.07	M	9,711.88	U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	
26th through the last	H		P	9,549.96	X	10,389.43
▶ Total liability for month	I	18,340.38	II	28,310.09	III	18,803.75

IV Total for quarter (add lines I, II, and III). This should equal line 16 above . . . . . ▶ 65,454.22

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Print Your Name and Title ▶ AGENT IN FACT Date ▶ 3/03/92 JA45

For Paperwork Reduction Act Notice, see page 2.

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Form 941 (Rev. January 1991)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

4141

► See Circular E for more information concerning employment tax returns.

Please type or print.

OMB No. 1545-0029
Expires: 5-31-93

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

94-2420391 JUN91
FIOR D'ITALIA INC.
601 UNION ST.
SAN FRANCISCO CA 94133

COPY

If you do not have to file returns in the future, check here . . . ► ☐ Date final wages paid . . . ►

If you are a seasonal employer, see Seasonal employers on page 2 and check here . ► ☐

1a	Number of employees (except household) employed in the pay period that includes March 12th . ►	1a	
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) . . ►	1b	–
2	Total wages and tips subject to withholding, plus other compensation . . . . . ►	2	270,514.20
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. . . ►	3	25,121.81
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) . . ►	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	25,121.81
6a	Taxable social security wages (Complete line 7) $ 199,689.30 × 12.4% (.124) =	6a	24,761.47
b	Taxable social security tips $ 63,921.00 × 12.4% (.124) =	6b	7,926.20
7	Taxable Medicare wages and tips $ 263,610.30 × 2.9% (.029) =	7	7,644.70
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	40,332.37
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) . . .	9	.04 F/C
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ►	10	40,332.41
11	Backup withholding (see instructions) . . . . . ►	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year.	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13) . . . . . ►	14	65,454.22
15	Advance earned income credit (EIC) payments made to employees, if any . . . . . ►	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	65,454.22
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records. ►	17	65,454.22
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS . . . ►	18	
19	Overpayment, if line 17 is more than line 16, enter here ► $ _____ and check if to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
Check only if you made deposits using the 95% rule ► ☐ Check only if you are a first time 3-banking-day depositor . . . ► ☐

Do NOT Show Federal Tax Deposits Here

Date wages paid	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A		I	9,048.25	Q	
4th through 7th	B	8,917.31	J		R	
8th through 11th	C		K		S	
12th through 15th	D		L		T	8,414.32
16th through 19th	E	9,423.07	M	9,711.88	U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	
26th through the last	H		P	9,549.96	X	10,389.43
Total liability for month	I	18,340.38	II	28,310.09	III	18,803.75

► IV Total for quarter (add lines I, II, and III). This should equal line 16 above . . . . . ► 65,454.22

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ►

Print Your Name and Title ► AGENT IN FACT

Date ► JUNE 30, 1991

Form **941**
(Rev. January 1991)
Department of the Treasury
Internal Revenue Service

4141

Employer's Quarterly Federal Tax Return

▶ See Circular E for more information concerning employment tax returns.

Please type or print.

OMB No. 1545-0029
Expires: 5-31-93

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

94-2420391 SEP91
FIOR D'ITALIA INC.
601 UNION ST.
SAN FRANCISCO CA 94133

YOUR COPY

If you do not have to file returns in the future, check here . . . ▶ ☐ Date final wages paid . . . ▶

If you are a seasonal employer, see Seasonal employers on page 2 and check here . ▶ ☐

1a	Number of employees (except household) employed in the pay period that includes March 12th . ▶	1a	
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) . . ▶ 1b –		
2	Total wages and tips subject to withholding, plus other compensation . . . . . ▶	2	228,219.72
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. . . ▶	3	21,611.04
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) . . ▶	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions) . . . ▶	5	21,611.04
6a	Taxable social security wages (Complete line 7) $ 170,314.72 × 12.4% (.124) =	6a	21,119.03
b	Taxable social security tips $ 57,905.00 × 12.4% (.124) =	6b	7,180.22
7	Taxable Medicare wages and tips $ 228,219.72 × 2.9% (.029) =	7	6,618.37
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	34,917.62
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) . . .	9	.01 F
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ▶	10	34,917.63
11	Backup withholding (see instructions)	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year. . . . . ▶	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13)	14	56,594.67 ☐
15	Advance earned income credit (EIC) payments made to employees, if any . . . . . ▶	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	56,594.67
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records. ▶	17	56,594.67
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS . . . . ▶	18	
19	Overpayment, if line 17 is more than line 16, enter here ▶ $ _____ and check if to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
Check only if you made deposits using the 95% rule ▶ ☐ Check only if you are a first time 3-banking-day depositor. . . ▶ ☐

Do NOT Show Federal Tax Deposits Here

Show tax liability here, not deposits. IRS gets deposit data from FTD coupons.

Date wages paid	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A		I		Q	
4th through 7th	B		J		R	6,753.26
8th through 11th	C	8,791.66	K	8,640.23	S	
12th through 15th	D	33.73	L		T	
16th through 19th	E		M		U	
20th through 22nd	F		N	10,335.60	V	9,445.77
23rd through 25th	G		O	74.60	W	
26th through the last	H	10,319.82	P		X	
Total liability for month	I	19,145.21	II	19,250.43	III	18,199.03
IV Total for quarter (add lines I, II, and III). This should equal line 16 above . . . . . ▶						56,594.67

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶

Print Your Name and Title ▶ AGENT IN FACT

Date ▶ OCT 31,19

Form 941 (Rev. January 1991)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax R

4141

► See Circular E for more information concerning employment

Please type or print.

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

94-2420391 JUN91 4th Qtr
FIOR D'ITALIA INC.
601 UNION ST.
SAN FRANCISCO CA 94133

COPY

84

If you do not have to file returns in the future, check here . . . ► ☐ Date final wages paid . . . ►

If you are a seasonal employer, see Seasonal employers on page 2 and check here . ► ☐

1a	Number of employees (except household) employed in the pay period that includes March 12th . ►	1a	
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) . . ► 1b –		
2	Total wages and tips subject to withholding, plus other compensation . . . . . ►	2	251,181 98
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. . . ►	3	25,121 81
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) . . ►	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	25,121 81
6a	Taxable social security wages (Complete line 7) $ 166,811.98 × 12.4% (.124) =	6a	24,760 47
b	Taxable social security tips $ 72,250.00 × 12.4% (.124) =	6b	7,926 20
7	Taxable Medicare wages and tips $ 251,181.98 × 2.9% (.029) =	7	7,284 70
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	40,331 37
9	Adjustment of social security and Medicare taxes (see instructions for required explanation) . . .	9	04 F/O
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ►	10	40,331 41
11	Backup withholding (see instructions)	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year. . . . . ►	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13)	14	65,453 22
15	Advance earned income credit (EIC) payments made to employees, if any . . . . . ►	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	65,453 22
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records. ►	17	65,453 22
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS . . . ►	18	
19	Overpayment, if line 17 is more than line 16, enter here ► $ _____ and check if to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
Check only if you made deposits using the 95% rule ► ☐ Check only if you are a first time 3-banking-day depositor. . . ► ☐

Do NOT Show Federal Tax Deposits Here

Date wages paid	First month of quarter		Second month of quarter		Third month of quarter	
► 1st through 3rd	A		I	9,048.25	Q	
4th through 7th	B	8,917.31	J		R	
8th through 11th	C		K		S	
12th through 15th	D		L		T	8,414.32
16th through 19th	E	9,423.07	M	9,711.88	U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	
26th through the last	H		P	9,549.96	X	10,389.43
► Total liability for month	*I*	18,340.38	*II*	28,310.09	*III*	18,803.75
IV Total for quarter (add lines *I*, *II*, and *III*). This should equal line 16 above . . . . . ►						65,454.22

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ► Print Your Name and Title AGENT IN FACT

nployment Development Departme

Sacramento CA 94247-0001

941 Employer's Quarterly Federal Tax Return

(Rev. January 1991)

Department of the Treasury
Internal Revenue Service

4141 ▶ See Circular E for more information concerning employment tax returns.

OMB No. 1545-0029
Expires: 5-31-93

1992

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

94-2520391 MARV

FIDE

6001 UNION ST

SAN FRANCISCO CA 94133

DELINQUENT IF NOT POSTMARKED OR RECEIVED BY

DATE

Q1	# 48,184
Q2	51,666
Q3	54,378
Q4	66,600
Total	220,828

Reminder Wife $80.

COPY

If you do not have to file returns in the future, check here ▶ and enter date final wages paid ▶

If you are a seasonal employer, see Seasonal employers on page 2 and check here ▶

1a	Number of employees (except household) employed in the pay period that includes March 12th ▶	1a
b	If you are a subsidiary corporation AND your parent corporation files a consolidated Form 1120, enter parent corporation employer identification number (EIN) ▶	1b
2	Total wages and tips, plus other compensation ▶	2 195,666 78

BEST AVAILABLE COPY

3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. ▶		3 16,814.42
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) ▶		4
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)		5 16,814.42
6a	Taxable social security wages (Complete line 6a, 6b, 7, and 8 only if this is the Final return.)	$ 147,482.78 × 12.4% (.124) =	6a 18,287.86
b	Taxable social security tips	$ 48,184.00 × 12.4% (.124) =	6b 5,974.82
7	Taxable Medicare wages and tips	$ 195,666.78 × 2.9% (.029) =	7 5,674.34
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)		8 29,937.02
9	Adjustment of social security and Medicare taxes (see instructions for required explanation)		9 .03 F/C
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ▶		10 29,937.05
11	Backup withholding (see instructions)		11
12	Adjustment of backup withholding tax for preceding quarters of calendar year		12
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)		13
14	Total taxes (add lines 5, 10, and 13)		14 46,751.47
15	Advance earned income credit (EIC) payments made to employees, if any ▶		15
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability) ▶		16 46,751.47
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records. ▶		17 46,751.47
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to IRS ▶		18
19	Overpayment, if line 17 is more than line 16, enter here ▶ $ and check if to be: Applied to next return ? OR Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
Check only if you made deposits using the 95% rule ▶ ☐ Check only if you are a first time 3-banking-day depositor. ▶ ☐

Do NOT Show Federal Tax Deposits Here

Date wages paid	Show tax liability here, not deposits. IRS gets deposit data from FTD coupons.					
	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A		I		Q	
4th through 7th	B		J	7,278.31	R	7,078.42
8th through 11th	C	9,081.51	K		S	
12th through 15th	D		L		T	
16th through 19th	E		M		U	
20th through 22nd	F		N	7,817.19	V	7,627.80
23rd through 25th	G	7,868.24	O		W	
26th through the last	H		P		X	
Total liability for month	I	16,949.75	II	15,095.50	III	14,706.22

IV Total for quarter (add lines I, II, and III). This should equal line 16 above ▶ 46,751.47

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ _____ Print Your Name and Title ▶ AGENT IN FACT Date ▶ APRIL 30,199

this page OR total of [illegible]

Form **941** (Rev. January 1992) — Department of the Treasury, Internal Revenue Service

Employer's Quarterly Federal Tax Return

4141 ▶ See Circular E for more information concerning employment tax returns.

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

Name (as distinguished from trade name)

FIOR D'ITALIA INC

Trade name, if any

Employer identification number

601 UNION ST.

Address (number and street)

94-2420321

SAN FRANCISCO, CA 94133

City, State, and ZIP code

YOUR COPY

If you do not have to file returns in the future, check here ▶ ☐ Date final wages paid ▶

If you are a seasonal employer, see Seasonal employers on page 2 and check here ▶ ☐

1	Number of employees (except household) employed in the pay period that includes March 12th ▶	1	
2	Total wages and tips subject to withholding, plus other compensation ▶	2	228,722.67
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. ▶	3	19,233.54
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) ▶	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	19,233.54
6a	Taxable social security wages (Complete line 7) $ 177,056.67 × 12.4% (.124) =	6a	21,955.03
b	Taxable social security tips $ 51,666.00 × 12.4% (.124) =	6b	6,406.58
7	Taxable Medicare wages and tips $ 228,722.67 × 2.9% (.029) =	7	6,632.96
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	34,994.57
9	Adjustment of social security and Medicare taxes (see instructions for required explanation)	9	.03 F/U
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ▶	10	34,994.60
11	Backup withholding (see instructions)	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13)	14	54,228.14
15	Advance earned income credit (EIC) payments made to employees, if any ▶	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	54,228.14
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records ▶	17	54,228.14
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to Internal Revenue Service ▶	18	
19	Overpayment, if line 17 is more than line 16, enter excess here ▶ $ and check if to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.

If you made deposits using the 95% rule, check here ▶ ☐ If you are a first time 3-banking-day depositor, check here ▶ ☐

DO NOT Show Federal Tax Deposits Here

Show tax liability here, not deposits. The IRS gets deposit data from FTD coupons.

Date wages paid	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A	7,079.86	I	7,599.45	Q	
4th through 7th	B		J		R	
8th through 11th	C		K		S	
12th through 15th	D		L	7,695.89	T	7,369.45
16th through 19th	E	8,277.03	M		U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	
26th through the last	H		P	8,186.30	X	8,020.16
Total liability for month	I	15,356.89	II	23,481.64	III	15,389.61

IV Total for quarter (add lines I, II, and III). This should equal line 16 above ▶ 54,228.14

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶

Print Your Name and Title ▶ AGENT IN FACT Date ▶ JULY 31, 199

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Form **941**
(Rev. January 1992)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

4141 ▶ See Circular E for more information concerning employment tax returns.
Please type or print clearly.

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

Name (as distinguished from trade name)
FIGR-O-MATIC
Trade name, if any
601 UNION ST.
Address (number and street)
SAN FRANCISCO, CA 94133
City, state, and ZIP code
Employer identification number: 94-2420391

YOUR COPY

If you do not have to file returns in the future, check here ▶ ☐ Date final wages paid ▶
If you are a seasonal employer, see Seasonal employers on page 2 and check here ▶ ☐

1	Number of employees (except household) employed in the pay period that includes March 12th ▶	1	
2	Total wages and tips subject to withholding, plus other compensation ▶	2	236,699.32
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. ▶	3	23,128.01
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) ▶	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4—see instructions)	5	23,128.01
6a	Taxable social security wages (Complete line 7) $ 182,324.32 × 12.4% (.124) =	6a	22,608.22
b	Taxable social security tips (Complete line 7) $ 54,375.00 × 12.4% (.124) =	6b	6,742.50
7	Taxable Medicare wages and tips $ 236,699.32 × 2.9% (.029) =	7	6,864.28
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	36,215.00
9	Adjustment of social security and Medicare taxes (see instructions for required explanation)	9	.01
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9—see instructions) ▶	10	36,215.01
11	Backup withholding (see instructions)	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13)	14	59,343.02
15	Advance earned income credit (EIC) payments made to employees, if any ▶	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	59,343.02
17	Total deposits for quarter, including overpayment applied from a prior quarter, from your records ▶	17	59,343.02
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to Internal Revenue Service ▶	18	
19	Overpayment, if line 17 is more than line 16, enter excess here ▶ $ and check it to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
If you made deposits using the 95% rule, check here ▶ ☐ If you are a first time 3-banking-day depositor, check here ▶ ☐

DO NOT Show Federal Tax Deposits Here

Show tax liability here, not deposits. The IRS gets deposit data from FTD coupons.

Date wages paid	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A		I		Q	
4th through 7th	B		J	9,180.00	R	9,664.66
8th through 11th	C	9,707.01	K		S	
12th through 15th	D		L		T	
16th through 19th	E		M		U	9,980.31
20th through 22nd	F		N	10,418.22	V	
23rd through 25th	G	10,392.82	O		W	
26th through the last	H		P		X	
Total liability for month	I	20,099.83	II	19,598.22	III	19,644.97

IV Total for quarter (add lines I, II, and III). This should equal line 16 above ▶ 59,343.02

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶ Print Your Name and Title ▶ AGENT IN FACT Date ▶ OCT. 31, 19

CFINCPROS7 1991 28

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941 (January 1992)
Department of the Treasury
Internal Revenue Service

Employer's Quarterly Federal Tax Return

▶ See Circular E for information concerning employment tax returns.

Type or print your name, address, employer identification number, and calendar quarter of return as shown on original.

Name (as distinguished from trade name)
FIOR D' ITALY
Trade name, if any
601 UNION ST
Address (number, city, and street)
SAN FRANCISCO CA 94133

Employer identification number
94-2520391

YOUR COPY

If you do not have to file returns in the future, check here ▶ ☐ and enter date final wages paid ▶
If you are a seasonal employer, see Seasonal employers on page 2 and check here ▶ ☐

1	Number of employees (except household) employed in the pay period that includes March 12th ▶	1	
2	Total wages and tips subject to withholding, plus other compensation ▶	2	287,705 47
3	Total income tax withheld from wages, tips, pensions, annuities, sick pay, gambling, etc. ▶	3	29,865 83
4	Adjustment of withheld income tax for preceding quarters of calendar year (see instructions) ▶	4	
5	Adjusted total of income tax withheld (line 3 as adjusted by line 4 — see instructions)	5	29,865 83
6a	Taxable social security wages (Complete line 7.) $216,603.37 × 12.4% (.124) =	6a	26,858 83
b	Taxable social security tips $66,620.00 × 12.4% (.124) =	6b	8,260 88
7	Taxable Medicare wages and tips $287,705.47 × 2.9% (.029) =	7	8,343 46
8	Total social security and Medicare taxes (add lines 6a, 6b, and 7)	8	43,463 17
9	Adjustment of social security and Medicare taxes (see instructions for required explanation)	9	01 F/U
10	Adjusted total of social security and Medicare taxes (line 8 as adjusted by line 9 — see instructions) ▶	10	43,463 18
11	Backup withholding (see instructions)	11	
12	Adjustment of backup withholding tax for preceding quarters of calendar year	12	
13	Adjusted total of backup withholding (line 11 as adjusted by line 12)	13	
14	Total taxes (add lines 5, 10, and 13)	14	73,329 01
15	Advance earned income credit (EIC) payments made to employees, if any	15	
16	Net taxes (subtract line 15 from line 14). This should equal line IV below (plus line IV of Schedule A (Form 941) if you have treated backup withholding as a separate liability)	16	73,329 01
17	Total deposits for quarter, including overpayment applied from a prior quarter and from your records ▶	17	73,329 01
18	Balance due (subtract line 17 from line 16). This should be less than $500. Pay to Internal Revenue Service ▶	18	
19	Overpayment, if line 17 is more than line 16, enter excess here ▶ $ and check if to be: ☐ Applied to next return OR ☐ Refunded.		

Record of Federal Tax Liability (You must complete if line 16 is $500 or more and Schedule B is not attached.) See instructions before checking these boxes.
If you made deposits using the 95% rule, check here ▶ ☐ If you are a first time 3-banking-day depositor, check here ▶ ☐

DO NOT Show Federal Tax Deposits Here

Date wages paid	Show tax liability here, not deposits. The IRS gets deposit data from FTD coupons.					
	First month of quarter		Second month of quarter		Third month of quarter	
1st through 3rd	A	9,759.19	I		O	
4th through 7th	B		J		R	
8th through 11th	C		K		S	9,021.90
12th through 15th	D		L	10,316.38	T	
16th through 13th	E	9,572.94	M		U	
20th through 22nd	F		N		V	
23rd through 25th	G		O		W	12,088.56
26th through the last	H	10,423.78	P	11,346.26	X	
Total liability for month	I	29,755.91	II	22,462.64	III	21,110.46

IV Total for quarter (add lines I, II, and III). This should equal line 16 above ▶ 73,329.01

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature ▶

Print Your Name and Title ▶ AGENT IN FACT Date ▶ JAN 31, 19

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TAB M

POWER & COLEMAN
ATTORNEYS AT LAW
COURTHOUSE PLAZA, SUITE 1107
2300 CLARENDON BOULEVARD
ARLINGTON, VIRGINIA 22201

(703) 841-13304721
FAX (703) 841-1822

THOMAS W. POWER
R. LANCE ELLIOTT
JAMES M. COLEMAN
TRACY J. POWER

WASHINGTON, DC OFFICE
4721 MACARTHUR BOULEVARD
WASHINGTON, DC 20007
(202) [Illegible]

March 28, 1996

PRIVILEGED AND CONFIDENTIAL

You have asked whether or not _____ should pay a FICA tax assessment pursuant to a February 16, 1996 Notice and Demand for tip income allegedly reported by ____ employees on Form 4137 and their 1040 income tax filing for the year 1992. You have indicated that you requested and IRS identified the specific employees who reported additional tip income and the amount of such income. You have confirmed that the individual was in fact an employee of ____ and the amount of tips reported was equal to the amount of allocated tips shown on that employee's Form W-2 tax 1992.

In light of the fact that there has apparently been a determination of the amount of additional tip income earned on an individual basis, that the earnings will be credited to the social security benefit of the individual and that the assessment is within the statute of limitations, I believe the taxes are due and should be

paid. Please note that any assessment for additional taxes based upon additional tips earned during 1991 would be outside of the statute assuming all Forms 941 were filed by April 15, 1992. Any additional assessments based upon 1992 tip earnings after April 15, 1996 would similarly be barred.

In my opinion, any future notice allegedly based upon additional employees Form 4137 tip reporting should only be paid after IRS identification of individuals and amounts and similar satisfactory confirmation by the company. Attention should also be paid to the statute of limitations issue.

Please call if you have any questions.

Cordially,

/s/ TRACY J. POWER
TRACY J. POWER

Internal Revenue Service
District Director

Department of the Treasury
310 W. Wisconsin Avenue
Milwaukee, WI 53203

Date: FEB 16 1996

IP

Dear Taxpayer:

The Internal Revenue Service received Form(s) 4137 from your employee(s) showing tip amounts that have not been reported to you. Internal Revenue Code (IRC) section 3121(q) stipulates that the employer is liable for the employer portion of IRC section 3111 FICA tax on such tips.

This letter serves as your notice and demand, in accordance with IRC section 3121(q), for payment of the employer's IRC Section 3111 FICA tax in the amounts of $0.00 on $0 in unreported tips received by your employee(s) during the period January 1, 1991 through December 31, 1991, and $85.60 on $1,119 in unreported tips received by your employee(s) for the period January 1, 1992 through December 31, 1992. The unreported tip amount is the amount shown by your employee(s) on Form 4137.

You should report this tax as an adjustment to FICA taxes on your Form 941 for the calendar quarter in which this notice and demand is made. Please attach a copy of this notice and demand to your Form 941.

To avoid any possible deposit penalty, the tax must be deposited at an authorized bank, using a Federal Tax Deposit Coupon - Form 8109B, within your prescribed

depository rules. If you have a payroll service depositing your payroll taxes, they should be notified of this notice immediately.

If you have any further questions, please call Enrique De Orbeta, Revenue Agent, at 414-297-4144.

Sincerely,

/s/ RICHARD C. [ILLEGIBLE]
ROBERT E. BRASSIL
District Director

TAB N

[Names Omitted]

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

No. C-97-4613-CAL

FIOR D'ITALIA, PLAINTIFF

v.

UNITED STATES AMERICA, DEFENDANT

[Filed: Mar. 8, 1999]
[Entered in Civil Docket: Mar. 15, 1999]

STIPULATION FOR ENTRY OF JUDGMENT AND ORDER THEREON

Pursuant to Court's September 18, 1998 Opinion and Order on Cross Motions for Summary Judgment, the United States of America, by its undersigned counsel, and Fior d'Italia, by its undersigned counsel, stipulate and hereby agree, without prejudice to either party's right to appeal, as follows:

Judgment be entered against the United States of America and in favor of plaintiff Fior d'Italia for the 1994 tax year for form 941 employment taxes in the amount of $18.34 together with interest thereon at the

lawful rate prescribed by 28 U.S.C. § 1961(c)(1) from February 1, 1995 until paid.

ROBERT S. MUELLER, III
United States Attorney

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PURSUANT TO STIPULATION, IT IS SO ORDERED.

Dated: 3/8/99, 1998

CHARLES A. LEGGE
UNITED STATES DISTRICT JUDGE

TAB O

[Names Omitted]

UNITED STATES DISTRICT COURT FOR THE
NORTHERN DISTRICT OF CALIFORNIA
SAN FRANCISCO DIVISION

No. C-97-4613-CAL

FIOR D'ITALIA, INC., PLAINTIFF

v.

UNITED STATES AMERICA, DEFENDANT

[Filed: May 7, 1999]

NOTICE OF APPEAL

The United States of America hereby appeals to the Ninth Circuit Court of Appeals pursuant to Rule 3, F.R.A.P. from the Judgment, the Order on Motion for Reconsideration, and the Opinion and Order on Cross-Motions for Summary Judgment.

The parties to the Judgment appealed from and the names and addresses of their respective attorneys are as follows:

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TAB P

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 99-16021
CT/AG#: CV-97-04613-CAL

FIOR D'ITALIA, INC., PLAINTIFF-COUNTER-DEFENDANT-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-COUNTER-CLAIMANT-APPELLANT

[May, 30 2001]
[MANDATE ISSUED]

APPEAL FROM the United States District Court for the Northern District of California (San Francisco).

THIS CAUSE came on to be heard on the Transcript of the Record from the United States District Court for the Northern District of California (San Francisco) and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this cause be, and hereby is AFFIRMED.

Filed and entered March 7, 2001

TAB Q

The following two documents were not offered in the district court. They were attached to respondent's appellate brief and were not part of the record in the district court. Petitioner has agreed to include these documents in the Joint Appendix at respondent's request, but does not agree that these documents are part of the record of this case.

CAVEAT: THE FOLLOWING TWO DOCUMENTS WERE NOT OFFERED IN THE DISTRICT COURT. THEY WERE ATTACHED TO RESPONDENT'S APPELLATE BRIEF AND WERE NOT PART OF THE RECORD IN THE DISTRICT COURT. PETITIONER HAS AGREED TO INCLUDE THESE DOCUMENTS IN THE JOINT APPENDIX AT RESPONDENT'S REQUEST, BUT DOES NOT AGREE THAT THESE DOCUMENTS ARE PART OF THE RECORD OF THIS CASE.

[DEC 11, 1996]

MEMORANDUM FOR REGIONAL CHIEF
COMPLIANCE OFFICERS

FROM: Thomas J. Smith
Assistant Commissioner (Examination)
CP:EX

SUBJECT: Impact of Decision in *The Bubble Room, Inc. v. U.S.*, No. 94-616 T (CT. Cl. Oct. 21, 1996)

On October 21, 1996, the United States Court of Federal Claims ruled against the Internal Revenue Service (IRS) in the above cited case. The court stated that the IRS improperly assessed and collected an *employer only* Federal Insurance Contributions Act tax based on an aggregate estimate made by the IRS of tips allegedly received by the employees of The Bubble Room. In ruling against the IRS, the court acknowledged that we are faced with a tremendous amount on unreported tip income within the food service industry. The decision of the court does not

alter the fact that this problem exists and we need to do all we can to address this area of noncompliance. In fact, the court spoke positively of the current IRS Tip Rate Alternative Commitment (TRAC) program as a method to address this area of noncompliance.

This decision dealt with the proper versus improper use of an "audit tool" by the IRS, and has no direct impact on our efforts in the Tip Rate Determination and Education Program. The food service industry recognizes that there is a significant amount of unreported tip income and that the IRS cannot ignore this. We have made excellent progress in getting the industry to recognize the benefits of signing up for TRAC. From June 1995, when TRAC was first released, more than 2,600 TRAC agreements representing more than 16,000 establishments have been secured.

No final decision has been made on the appeal of *The Bubble Room.* Until all issues relative to this court case are resolved, we are issuing interim guidance on how to proceed in dealing with unreported tip income. Our guidance to the field is:

1. We need to improve the compliance level with filing and accuracy of Form 8027;
2. Identify restaurants that are likely candidates for the TRAC/TRDA program;
3. We should be prepared to conduct individual employee audits in appropriate situations; and

REGIONAL CHIEF COMPLIANCE OFFICERS

4. We should modify our position in how we handle tip examinations. We can no longer have employer-only assessments. Any assessments made should be based on amounts from either

Form 4137, *Social Security and Medicare Tax on Unreported Tip Income*, (filed by the employee with the employee's Form 1040) or amounts reflected on Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer*, prepared at the conclusion of an employee tip examination.

We are attaching our summary of *The Bubble Room* decision. A copy of the court has been faxed to each of the Employment Tax Regional analysts. We will continue to share any information on the impact of this court decision. We encourage you to continue to promote the Tip Rate Determination and Education Program and continue in a joint effort to increase compliance in tip reporting.

Attachment

CP:EX:ST/MBeaulieu/rb/622-4386/12-2-96/memo.bbl
Revised: jma/12-10-96

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
JUNE 16, 1998

[Received: June 24, 1998]

MEMORANDUM FOR REGIONAL CHIEF COMPLIANCE OFFICERS

FROM: Thomas R. Burger
Director, Office of Employment Tax Administration & Compliance

SUBJECT: No Employer-Only Assessments on Unreported Tip Income

In memos issued on December 11, 1996 and September 25, 1997, we sent guidance for you to distribute in the field, regarding employer-only assessments. We wish to emphasize that policy procedures again. Any assessments made against the employer must mirror those first made against the individual employees. Also, any Internal Revenue Code section 3121(q) assessments should be used as a tool to increase compliance and never as a threat.

Assessments made against both the employer and the tipped employee should be based on amounts from either Form 4137, *Social Security and Medicare Tax on Unreported Tip income* (filed by the employee with the employee's Form 1040) or amounts reflected on Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer*, prepared at the conclusion of an employee tip examination.

There is some proposed legislation that would codify the TRAC (Tip Reporting Alternative Commitment) agreement and prevent the IRS from conducting

employer-only assessments. Also, H.R. 2676 of the Restructuring Bill, includes a provision to prohibit the IRS from coercing or threatening taxpayers into signing up for a TRAC agreement. We have also received congressional inquires that employer-only assessments are still being performed by IRS examiners, although our current policy prevents this. Please ensure that all effected IRS personnel working on the Tip Initiative follow the current procedures related to tip examinations. Most important, employees must under no circumstances use or imply the threat of an audit when soliciting participants to sign up for either a TRAC or a TRDA (Tip Rete Determination Agreement).

Please distribute this information to all effected individuals. If you have any questions, please give me a call at (202) 622-2479, or a member of your staff may contact Ida Volz, Program Analyst at (208) 321-2805.

If your management staff or coordinators have any questions, they may contact Regional Analyst Gary Letham at (972) 308-1551.

FEB 2 5 2002

No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the employer's share of the Federal Insurance Contribution Act (FICA) tax on employee tip income must be determined by accumulating the result of individual audits of individual employees or may instead be based on a reasonable estimate of the aggregate amount of tips received by all employees.

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In the Supreme Court of the United States

No. 01-463

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-33a) is reported at 242 F.3d 844. The opinion of the district court (Pet. App. 34a-51a) is reported at 21 F.Supp.2d 1097. The order of the district court denying reconsideration (Pet. App. 52a-53a) is unreported.

JURISDICTION

The judgment of the court of appeals was filed on March 7, 2001. A petition for rehearing was denied on May 18, 2001. Pet. App. 54a. On August 3, 2001, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to September 15, 2001. The petition for a writ of certiorari was filed on September 14, 2001, and was granted on January 11, 2002. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of Sections 446, 3111, 3121, 6053, and 6201 of the Internal Revenue Code, 26 U.S.C. 446, 3111, 3121, 6053, and 6201, are set forth at Pet. App. 55a-62a.

STATEMENT

1. Respondent operates a restaurant in San Francisco, California. Some employees of the restaurant (such as waiters) receive tips directly from customers. Other employees (such as table bussers) receive tips indirectly when a waiter shares a portion of the tips received from the customer. Pet. App. 1a-2a, 4a-5a. Tips received by an employee who receives more than $20 in tips in any month are treated as "wages" for Federal Insurance Contribution Act (FICA) tax purposes. Both the employee and the employer are required to pay FICA taxes on the amount of such tips that are not in excess of the Social Security wage base. 26 U.S.C. 3111, 3121(a) and (q).[1]

Restaurant employers as well as their tipped employees are subject to certain reporting requirements with respect to tip income. Employees are required to make monthly reports to their employer of the tips they receive that constitute "wages" for FICA tax purposes, using IRS Form 4070 or a similar written substitute form. 26 U.S.C. 6053(a); 26 C.F.R. 31.6053-1(a)-(c). Restaurants with ten or more employees are required to make annual reports (Form 8027) to the Internal Revenue Service of tips reported to them by their employees. 26 U.S.C. 6053(c)(1), (4).

---

[1] These limits on the amount of tips that constitute "wages" are referred to as the "wages band" for these tax calculations. Pet. App. 5a.

2. Respondent filed Forms 8027 that state that its employees reported tips of $247,181 for 1991 and $220,845 for 1992.[2] These Forms also showed, however, that the total amount of tips reported on customer credit charge slips alone was $364,786 in 1991 and $338,161 in 1992. Pet. App. 2a n.2; J.A. 38-39. Respondent nonetheless calculated its employer share of the FICA tax only on the lesser tip amounts that its employees had reported receiving. Pet. App. 35a.

Because of the discrepancy in these reported tip amounts, the Internal Revenue Service conducted a compliance check of respondent's restaurant. The credit charge slip information reported by respondent revealed an average tip rate of 14.49% for 1991 and 14.29% for 1992.[3] Pet. App. 2a-3a; J.A. 56. Multiplying these tip rates by respondent's gross receipts for those years—and then subtracting the total tips reported by respondent on Form 8027—indicated that unreported tips were approximately $156,545 for 1991 and $147,529 for 1992. Pet. App. 3a n.3; J.A. 52, 56. Applying the 7.65% FICA tax rate to these unreported tip amounts resulted in FICA tax deficiencies for respondent in the amount of $11,976 for 1991 and $11,286 for 1992. The Service sent a notice and demand for payment of these deficiencies to respondent pursuant to 26 U.S.C. 3121(q). J.A. 41-42. In calculating the amount of respondent's FICA tax deficiencies, the Service did not conduct individual audits to determine the unreported

---

[2] The amounts reported for 1991 reflect $30,977 for indirectly tipped employees and $216,204 for directly tipped employees. The amounts reported for 1992 reflect $19,155 for indirectly tipped employees and $201,690 for directly tipped employees. J.A. 38-39.

[3] In 1991, 90% of taxpayer's sales were made on charge card slips. In 1992, 92% of sales were by charge. J.A. 38-39.

tips received by each individual employee. Pet. App. 6a.

3. Respondent paid a portion of the tax and filed this refund suit. J.A. 24. The government assessed the total FICA tax liability of $23,262 asserted in the notice and demand for payment and filed a counterclaim in this suit for the unpaid balance of the assessment. J.A. 31-33.

The parties filed cross-motions for summary judgment. Respondent did not dispute the reasonableness or accuracy of the Service's calculation of the amount of unreported tips. See Pet. App. 32a-33a, 36a; J.A. 35. Instead, respondent asserted that the Service lacks authority to assess taxes on employers by using an aggregate estimate of tip income. Respondent claimed that the Service must instead base any assessment of FICA taxes on employers on individual audits of individual employees.

The district court agreed with respondent. The court concluded that the Service is not permitted to make an assessment of employer FICA taxes on unreported tips until it first determines through individual audits the amount of unreported tips received by each individual employee. Pet. App. 34a-51a. Having concluded that the assessment was invalid, the court granted judgment to respondent on its refund claim and against the United States on its counterclaim for the balance of the taxes due. *Id.* at 51a. The parties then stipulated, without prejudice to their right to appeal, to the amount of the refund, and the court entered a judgment for that amount. J.A. 95-96.

4. a. The court of appeals affirmed in a 2-1 decision. Pet. App. 1a-33a. The majority concluded that the assessment was invalid because "[i]t rests on an estimate in circumstances where Congress has not authorized

the IRS to use estimation as an assessment method." *Id.* at 10a. While acknowledging that 26 U.S.C. 446 "has been interpreted as giving the IRS authority to make an assessment based on an estimate," the majority concluded that "the IRS cannot rely on section 446 as authority for the assessment here because the section does not apply to the collection of FICA taxes." Pet. App. 6a, 10a.

The majority also stated that the Service's method of estimation has "some serious flaws." Pet. App. 8a. The majority stated that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" (*ibid.*) because it is based on tips paid by customers using credit cards and "experience shows that charged tips generally exceed cash tips." *Id.* at 4a. The court also emphasized that "the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to employees by the restaurant" and does not "make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." *Id.* at 8a-9a. See note 1, *supra*.

The majority concluded that the Service may not employ an aggregate method for estimating the employer's FICA tax directly and must instead first "audit[] the employees' records or otherwise determin[e] the amount each employee earned in tips." Pet. App. 13a. The majority held that there is "no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned." *Ibid.*

b. Judge McKeown disagreed with the reasoning and conclusion of the majority. Pet. App. 18a-33a. She explained that, even if "the statutes do not directly address whether the IRS has the authority to make

aggregate assessments with respect to unreported tips, * * * they are certainly broad enough to permit the IRS to do so." *Id.* at 25a. She noted, moreover, that the decision in this case squarely conflicts with the decisions of several other circuits that have upheld the authority of the Internal Revenue Service to make assessments of employer FICA taxes based on aggregate calculations of unreported tip income. *Id.* at 19a-23a (citing *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d 990 (7th Cir. 2000); *Bubble Room, Inc.* v. *United States*, 159 F.3d 553 (Fed. Cir. 1998); *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d 1526 (11th Cir. 1997)). Judge McKeown emphasized that "[e]very circuit court that has addressed the aggregate assessment issue has come to the opposite conclusion from the majority." Pet. App. 22a. She concluded that these other circuits correctly rejected respondent's assertion that individual audits of individual employees must be conducted before FICA taxes may be assessed against the employer. *Id.* at 23a-30a.

c. The petition for rehearing en banc filed by the United States was denied by the court of appeals. Pet. App. 54a.

SUMMARY OF ARGUMENT

I. An "assessment" is the government's administrative determination of the amount of taxes due. 26 U.S.C. 6203. Unless the taxpayer establishes that the assessment is arbitrary and "without *any* foundation" (*United States* v. *Janis*, 428 U.S. 433, 441 (1976)), the assessment is entitled to a rebuttable "presumption of correctness" in tax litigation. This presumption of correctness places both the burden of going forward

and the burden of persuasion on the taxpayer in tax litigation.

Indeed, in a refund case, the taxpayer has a dual burden of proof: he must first prove that the assessment is erroneous and must then establish the correct amount of tax owed. It is not enough in a refund suit for the taxpayer to prove only that the government's assessment is procedurally or substantively defective. *United States* v. *Janis*, 428 U.S. at 440. If the assessment is invalid, the court may give it no weight but the taxpayer nonetheless retains the burden of establishing "the correct amount of his tax liability." *Ibid.*

By contrast, in a collection case brought to enforce an unpaid tax assessment, the government bears the initial burden of going forward, which it fulfills by establishing the fact and the amount of the unpaid assessment. Only if the assessment is shown to be "naked and without *any* foundation" will the government bear the burden of proof in a collection suit. *United States* v. *Janis*, 428 U.S. at 442.

Beyond this limited evidentiary function, the validity or invalidity of the assessment is not determinative of the ultimate liability of the taxpayer. Regardless of the allocation of the burden of proof, either party may offer competent evidence to establish the amount of taxes owed.

II. A. Respondent has not disputed the reasonableness or the factual basis of the government's assessment in this case. Instead, respondent claims only that the government may not lawfully make an assessment of the employer's share of FICA taxes owed on employee tip income by estimating the aggregate amount of tips received by all employees. Respondent claims, and the court of appeals agreed, that the government must instead make that assessment by

adding up individual determinations of employee tips for each employee, one at a time. In adopting that contention, the court of appeals did not point to any language in the Internal Revenue Code as support for its conclusion, and there is none.

The employer component of the FICA tax is a separate and distinct obligation from the employee component of that tax. These two separate exactions are imposed, determined and assessed under separate provisions of the Code. There is no requirement in these provisions that the employer tax be based upon, or be determined by, the amount of taxes owed or paid by employees. To the contrary, the governing statutory provisions make clear that the employer is required to pay taxes on the full amount of tips received by employees even when its employees fail to report, or pay taxes on, that amount.

B. Moreover, it is well established that the government may make tax assessments based upon aggregate estimates of relevant items of income. Section 6201 of the Code authorizes and directs the Internal Revenue Service to make "inquiries, determinations, and assessments of all taxes * * * imposed by this title." 26 U.S.C. 6201. The use of aggregate estimation methods in making such assessments has routinely been upheld as a reasonable method of determining a disputed factual issue. Since respondent has not disputed the reasonableness or factual basis for the assessment challenged in this case, it should have been upheld.

The majority's conclusion that an estimate of the employer's FICA tax liability is impermissible, and that what is required is an "employee-by-employee determination of the taxable tips each has earned" (Pet. App. 14a), departs from the established rule that estimation of controverted items of income is permissible. More-

over, the rule adopted by the court of appeals suffers from an obvious internal contradiction. If the IRS were to audit each employee to determine the unreported amount of tips each employee earned, those individual determinations would themselves necessarily be based on estimates. Cash tips that are not reported on the credit charge slips retained by the employer cannot be traced and determined by the government with precision. A method of estimation based on the average tip rate and the gross sales of the restaurant is far more likely to achieve factual accuracy than the individual audits suggested by the court of appeals.

C. The court of appeals erred in concluding that the aggregate estimate of tips made by the IRS in this case has "some serious flaws" (Pet. App. 8a). As other courts have emphasized, "whether there are flaws in the indirect formula used to estimate the FICA tax is a separate matter from whether the IRS has the authority to assess an employer-only FICA tax based on an aggregate estimate of unreported tip income." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 568. Even if there were proof that the *amount* of an assessment was incorrect, that would not make the assessment invalid. An "assessment is intended to be an estimate. It is expected to be rational, not flawless." *Dodge* v. *Commissioner*, 981 F.2d 350, 353 (8th Cir. 1992), cert. denied, 510 U.S. 812 (1993). When the reasonableness or amount of the assessment is challenged, "the proper course is not to void the assessment * * * but to determine what, if anything, the taxpayer owes the government." *United States* v. *Schroeder*, 900 F.2d 1144, 1148 (7th Cir. 1990).

In the present case, however, the taxpayer elected not to challenge the reasonableness or the factual basis of the assessment. There is thus no evidence in the

record of this case to support any claim that factual defects exist in the assessment. As Judge McKeown correctly stated in dissent, "the issue of accuracy is not before us, because [respondent] did not challenge the accuracy of the calculation * * * ." Pet. App. 33a.

ARGUMENT

I. A TAX ASSESSMENT HAS EVIDENTIARY IMPORTANCE, AND IS ENTITLED TO A "PRESUMPTION OF CORRECTNESS," UNLESS IT IS ARBITRARY OR LACKS A MINIMAL FACTUAL FOUNDATION

An "assessment" is the government's administrative determination of the amount of taxes due. 26 U.S.C. 6203. Unless the taxpayer establishes that the assessment is arbitrary and lacks even "a minimal factual foundation," the assessment is entitled to a rebuttable "presumption of correctness" in tax litigation. *Palmer* v. *IRS*, 116 F.3d 1309, 1312 (9th Cir. 1977). See *United States* v. *Janis*, 428 U.S. 433, 440 (1976); *United States* v. *Lease*, 346 F.2d 696, 700 (2d Cir. 1965). This presumption is based in part "on the probability of its correctness" and in part "upon considerations of public policy." *Psaty* v. *United States*, 442 F.2d 1154, 1160 (3d Cir. 1971) (footnotes and citations omitted):

> [A]s to the accuracy of the amount assessed, the presumption furthers the policy of requiring the taxpayer to meet certain bookkeeping obligations placed upon him by the Code. It also recognizes that the taxpayer has more readily available to him the correct facts and figures.

The "presumption of correctness" of the assessment places on the taxpayer "both the burden of going for-

ward and the burden of persuasion." *Ibid.*[4] Beyond this evidentiary function, however, the validity of the assessment is not determinative of the ultimate liability of the taxpayer.

For example, in any refund case, the taxpayer has a dual burden of proof: he must (i) first prove that the assessment of the tax is erroneous and (ii) then establish the *correct* amount of tax. *Compton* v. *United States*, 334 F.2d 212, 216 (4th Cir. 1964); *Taylor* v. *Commissioner*, 70 F.2d 619, 620 (2d Cir. 1934) (L. Hand, J.), aff'd *sub nom. Helvering* v. *Taylor*, 293 U.S. 507 (1935). It is not enough in a refund suit for the taxpayer to prove only that the government's assessment is procedurally or substantively defective. If the assessment is invalid, the court may ignore it but the taxpayer nonetheless retains the burden of establishing the amount of tax actually owed. An "action to recover on a claim for refund is in the nature of an action for money had and received, and it is incumbent on the claimant to show that the United States has money which belongs to him." *Lewis* v. *Reynolds*, 284 U.S. 281, 283 (1932). In a refund suit, "[it] is not enough for [the taxpayer] to demonstrate that the assessment of the tax for which refund is sought was erroneous in some respect." *United States* v. *Janis*, 428 U.S. at 440. See also *Ehlers* v. *Vinal*, 382 F.2d 58, 65-66 (8th Cir. 1967); *Roybark* v. *United States*, 218 F.2d 164 (9th Cir.

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[4] In 1998, Congress revised the burden of proof rules that apply to some (but not all) income tax and estate and gift tax cases that arise from examinations that are commenced after July 22, 1998. See 26 U.S.C. 7491(a) (Supp. V 1999); Pub. L. No. 105-206, § 3001(a), 112 Stat. 726. Those new burden of proof rules are inapplicable here both because this case does not involve an income tax or estate and gift tax and also because this case arose from an examination commenced before July 22, 1998.

1954). "[T]he ultimate question in a suit for refund is not whether the Government was wrong, but whether the plaintiff can establish that taxes were in fact overpaid * * * . The plaintiff, to prevail, must establish the exact amount for which she is entitled to recover." *Compton* v. *United States*, 334 F.2d at 216. Accord, *United States* v. *Janis*, 428 U.S. at 440; *Crosby* v. *United States*, 496 F.2d 1384, 1390 (5th Cir. 1974).[5]

By contrast, in a collection case brought by the government to enforce an unpaid tax assessment, the government bears the initial burden of going forward, which it fulfills by establishing the fact and the amount of the unpaid assessment. *Palmer* v. *IRS*, 116 F.3d at 1312; *Psaty* v. *United States*, 442 F.2d at 1160.[6] Once the government has satisfied its burden of going forward by introducing a copy of the record of assessment,[7] the ultimate burden of persuasion as to the

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[5] "The presumption of correctness must be distinguished from the taxpayer's burden of proof. A taxpayer has the burden of proving by a preponderance of the evidence that the assessment or determination is incorrect and, in a refund suit, the correct amount, if any, of tax. The presumption of correctness, on the other hand, assigns to the taxpayer the separate burden of coming forward with sufficient evidence from which a trier of fact could find in his favor or of suffering an adverse decision if evidence is not produced." M. Saltzman, *IRS Practice and Procedure* ¶ 1.05[2][c], at 1-37 (2d ed. 1991) (footnotes omitted).

[6] When, as in the present case, a refund suit is brought for the recovery of a divisible or periodic tax (such as the FICA tax), and the taxpayer has not paid the full amount of the tax prior to filing suit, the government commonly files a counterclaim for the unpaid balance. See J.A. 32-34; *Flora* v. *United States*, 362 U.S. 145, 166 (1960); *Caleshu* v. *United States*, 570 F.2d 711 (8th Cir. 1978).

[7] In support of its counterclaim in this case (see note 6, *supra*), the government introduced a certified copy of a Certificate of Assessments and Payments. J.A. 77-78. This document is suffi-

correctness of the tax liability shifts to the taxpayer. *United States* v. *Rexach*, 482 F.2d 10, 16-17 (1st Cir.), cert. denied, 414 U.S. 1039 (1973); *Psaty* v. *United States*, 442 F.2d at 1159-1160. See also *United States* v. *Janis*, 428 U.S. at 440; *Flora* v. *United States*, 362 U.S. at 166. If, however, the taxpayer establishes that the determinations made in the assessment are arbitrary, excessive, and without even a minimal factual foundation, the burden of proof shifts back to the government.[8] *Palmer* v. *IRS*, 116 F.3d at 1312. When an assessment is shown to be "naked and without *any* foundation," the government is required to bear the burden of proof in a collection suit. *United States* v. *Janis*, 428 U.S. at 442.

Thus, while an invalid assessment does not alter the burden of proof that the taxpayer always bears to establish the "correct" amount due in a refund case, a "naked" assessment that wholly lacks any foundation does shift the burden of proof to the government in a

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cient to establish the fact and the amount of the assessments. See *Hefti* v. *IRS*, 8 F.3d 1169, 1172 (7th Cir. 1993); *Hughes* v. *United States*, 953 F.2d 531, 540 (9th Cir. 1992); *United States* v. *Chila*, 871 F.2d 1015, 1018 (11th Cir.), cert. denied, 493 U.S. 975 (1989).

[8] "A court disregards the presumption [of correctness] where the Commissioner's method of determining the amount of the deficiency in income is arbitrary and invalid." M. Saltzman, *supra*, ¶ 1.05[2][c], at 1-38. Respondent did not argue below that the amount of the assessment was arbitrary, excessive, or otherwise unreasonable. Respondent's brief in the district court stated that, "[f]or purposes of this litigation alone, [t]axpayer does not dispute the facts, estimates and/or determinations used by IRS as a basis for its calculation of an amount of aggregate unreported tip income by all directly and indirectly tipped employees of the taxpayer collectively." J.A. 35. Respondent's sole challenge to the assessment was the contention that aggregate estimation of employee tips is an improper method of assessment that exceeds the agency's authority. Pet. App. 3a.

tax collection case. In neither situation, however, is the validity or invalidity of the assessment alone determinative of the ultimate question of the taxpayer's liability. Regardless of the allocation of the burden of proof, either party may offer competent evidence to establish the amount of taxes owed.[9]

The parties in this case, however, have treated the validity of the government's assessment as if it were determinative of the ultimate question of the tax liability of respondent.[10] While we do not seek to revive issues that were not preserved below (and have no need to do so), it is important, for clarity of analysis, to emphasize that the question whether a tax assessment is valid or invalid typically has a far narrower—and different—role in tax litigation than the parties have assigned to it in this case.

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[9] If a taxpayer's challenge to the government's method of making an assessment is rejected, the taxpayer is still entitled to raise factual contentions it may have concerning the amount of taxes owed. See note 5, *supra*. For example, in *Bubble Room, Inc.* v. *United States*, the court of appeals upheld the aggregate estimation method used by the government in making assessments of the employer share of FICA taxes on tip income but then remanded that case for the trial court to determine whether, notwithstanding the "presumption of correctness" of the assessment, the taxpayer could establish that a lesser amount of taxes is actually due and thereby show "that it is entitled to a partial refund of the FICA tax assessed against it." 159 F.3d at 568.

[10] In the present case, after the district court held that the Service is prohibited from "assessing employer FICA taxes by aggregating unidentified employees' unreported tips" (Pet. App. 50a), the parties stipulated to the entry of a final order in the district court that, subject to the retained right of the parties to appeal, provides (i) a refund of the taxes paid by respondent and (ii) a judgment in respondent's favor on the government's counterclaim for unpaid taxes from other periods. J.A. 95-96. The issue addressed in the court of appeals, and the question presented in the petition, is therefore limited to whether the method of assessment applied by the Service in this case is valid.

II. THE EMPLOYER'S SHARE OF THE FEDERAL INSURANCE CONTRIBUTION ACT (FICA) TAX ON EMPLOYEE TIP INCOME MAY BE DETERMINED AND ASSESSED BASED ON A REASONABLE ESTIMATE OF THE AGGREGATE AMOUNT OF TIPS RECEIVED BY ALL EMPLOYEES

1. a. The FICA tax has an employee portion and an employer portion. Each employee is required to pay a specified percentage of the "wages" he receives. 26 U.S.C. 3101. This employee portion of the tax is to be withheld from the employee's "wages" and remitted by the employer to the Treasury. 26 U.S.C. 3102(a). Congress has also imposed a separate FICA tax on every employer. 26 U.S.C. 3111. The employer portion of the FICA tax is a specified percentage of the "wages * * * paid by him with respect to employment." 26 U.S.C. 3111(a).[11] The term "wages" is defined for this purpose to mean "all remuneration for employment." 26 U.S.C. 3121(a). Tips received by an employee are included within this definition of "wages" unless the amount is less than $20 in any calendar month. 26 U.S.C. 3121(a)(12)(B); 26 C.F.R. 31.3121(a)(12)-1.

Section 3121(q) of the Code specifies that the tips received by an employee are "deemed to have been paid by the employer" for purposes of the FICA tax. 26

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[11] The employer portion of FICA taxes consists of two separate taxes, the Social Security tax in the amount of 6.2 percent of wages (26 U.S.C. 3111(a)) and the Medicare tax in the amount of 1.45 percent of wages (26 U.S.C. 3111(b)). The employee portion of FICA taxes similarly consists of the Social Security tax (26 U.S.C. 3101(a)) and the Medicare tax (26 U.S.C. 3101(b)).

U.S.C. 3121(q).[12] The statute thereby requires employers to pay the employer share of FICA taxes on all tips received by employees, up to the Social Security wage base. 26 U.S.C. 3121(q); see 26 U.S.C. 3121(a)(1) (limiting "wages" to amount of Social Security wage base).[13] As the Eleventh Circuit explained in *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529, Section 3121(q) provides "that an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips" and thereby "suggests that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined." The history of Section 3121(q) comports with this understanding, for the Conference Report on the bill that enacted this provision specifies that the employer portion of the FICA tax must be paid "on the total amount of wages and cash tips up to the Social Security wage base." H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 802 (1987). Accord, H.R. Rep. No. 391, 100th Cong., 1st Sess. Pt. 2, at 855 (1987).

Employees are required to report their tips in monthly statements to the employer, using IRS Form 4070 or a similar written substitute form. 26 U.S.C. 6053(a); 26 C.F.R. 31.6053-1(a)-(c). Under 26 U.S.C. 3102(c)(1), the employer's duty to collect the *employee*

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[12] Section 3121(q) was amended to include this text by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 9006(a), 101 Stat. 1330-288-1330-289. Prior to that amendment, an employer was liable for the employer share of FICA taxes for tips only to the extent of the excess of the federal minimum wage over the actual wage paid by the employer. 26 U.S.C. 3121(t) (1982).

[13] In 1991 and 1992 (the years at issue in this case), the Social Security wage base was $53,400 and $55,500, respectively.

share of FICA taxes applies only for the tips included in the employee's written statements under Section 6053(a). See 26 C.F.R. 31.3102-3(a)(2).[14] In 26 U.S.C. 3121(q), however, Congress provided a different rule for the *employer* portion of the FICA tax, specifying that, "where no statement including such tips was * * * furnished [by the employee]," the employer's obligation to pay its portion of the tax is deemed to have been incurred "on the date on which notice and demand for such taxes is made to the employer by the Secretary." Congress thereby again specified that the employer portion of the FICA tax may be assessed even when employees do not accurately report their tips.[15] *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529.

b. In this case, respondent paid the employer portion of the FICA tax only on the tips that were reported by the employees on their written statements under Section 6053(a). Sections 3111 and 3121(q) impose the employer portion of the FICA tax on *all* tips received by the employees, however, whether those tips have been reported or not. Pursuant to the authority conferred on the Treasury to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title" (26 U.S.C. 6201), the Service determined the aggregate amount of tips received by respondent's employees, and then assessed the resulting FICA taxes

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[14] The IRS therefore has not claimed that respondent has underwithheld the employee share of FICA taxes.

[15] The restriction under 26 U.S.C. 3102(c) concerning withholding of the Section 3101 employee tax does not apply to payment of the employer tax. See notes 12 & 14, *supra*, and accompanying text.

imposed on respondent with respect to those tips under 26 U.S.C. 3111.

The aggregate amount of tips received by respondent's employees was calculated by multiplying the average tip rate revealed on the charge sales records from respondent's restaurant (approximately 14%) times the aggregate sales made by that restaurant. Pet. App. 3a.[16] That estimate, based on the actual sales records of respondent's restaurant, is neither arbitrary nor "without *any* foundation" (*United States* v. *Janis*, 428 U.S. at 441). It is therefore entitled to a "presumption of correctness," which places the burden on respondent either to make a contrary factual showing or "suffer[] an adverse decision if evidence is not produced." M. Saltzman, *supra*, ¶ 1.05[2][c], at 1-37; see note 5, *supra*.

In this case, respondent expressly chose not to dispute the factual basis or the reasonableness of the government's assessment. J.A. 35. Respondent also offered no competing evidence to challenge the assessment. *Ibid.* On this record, judgment should therefore have been entered in the government's favor on both the refund and collection claims in this case. See pages 11-14, *supra*.

2. The court of appeals, however, adopted respondent's contention that this "aggregate" method of

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[16] This estimate was made necessary by the fact that the information returns provided by respondent revealed that actual tip income had been received by respondent's employees from charge sales alone that exceeded the total amount of tip income that respondent reported and on which respondent had paid FICA taxes. As the court of appeals noted, credit card receipts *alone* for 1991 and 1992 disclosed tips of $363,786 and $338,161 respectively, while respondent reported and paid FICA taxes on tips for those years of only $247,181, and $220,845. Pet. App. 2a n.2.

assessing the employer's portion of the FICA tax is legally impermissible. The court did not dispute that the employer portion of the tax may be assessed without making equivalent assessments against individual employees. The court reasoned, however, that the employer portion of the tax could lawfully be assessed only by adding up individual determinations of employee tips and not by estimating the aggregate amount of tips received by all employees. Pet. App. 13a.

The court did not point to any language in the Internal Revenue Code as support for its conclusion, and there is none. The employer portion of the FICA tax imposed by Section 3111 is a separate and distinct obligation from the employee tax in Section 3101. Nothing conditions the determination of one on any determination of the other. Section 3111(a) imposes the tax on an employer in an amount equal to a specified percentage of "the wages * * * paid by him with respect to employment." 26 U.S.C. 3111(a). Section 3121(q) defines wages to include tips but, for the reasons described above, refutes the suggestion that only the tips reported by the employee are to be treated as "wages" in determining the employer portion of the tax. See pages 15-17, *supra*. As the Eleventh Circuit correctly recognized, "the separation of these [employer FICA tax and employee FICA tax] provisions into different, parallel subchapters suggests that Congress contemplated that employees' and employer's shares could be imposed separately." *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1529.

The employer FICA taxes are computed as a percentage of "the wages * * * paid by [the employer] with respect to employment * * * ." 26 U.S.C. 3111(a), (b). Sections 3111(a) and (b) thus impose an accumulative tax liability for the employer based on the

employment of multiple employees. As shown on the Employer's Quarterly Federal Tax Return (Form 941) (J.A. 80-88), employer FICA taxes are imposed on the aggregate amount of tips and other wages received by *all* of the employer's employees. See *Bubble Room, Inc.* v. *United States*, 159 F.3d at 556 ("the employer FICA tax imposed by I.R.C. § 3111 is expressed in terms of the employees' aggregate tip income"). Because an employer is not assessed the employer FICA tax separately for each employee, there is no requirement that the tax be calculated based upon individual employee determinations. As the Federal Circuit emphasized in *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565, "the IRS is not obligated to assess FICA tax against each employee before it can assess FICA tax against the employer."

In short, nothing in the relevant statutes that impose the employer portion of the FICA tax requires the IRS to make the individual determinations required by the court of appeals. Section 3111 imposes a tax, and respondent has not disputed the reasonableness of the government's determination of the amount of the tax. See note 8, *supra*. That should be the end of the matter.

3. a. In rejecting the government's authority to make a reasonable aggregate estimate of the amount of tip income received by respondent's employees, the court of appeals acknowledged that 26 U.S.C. 446 "has been interpreted as giving the IRS authority to make an assessment based on an estimate." Pet. App. 6a (citing *McQuatters* v. *Commissioner*, 32 T.C.M. (CCH) 1122 (1973)). That statute provides that, "[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be

made under such method as, in the opinion of the Secretary, does clearly reflect income." 26 U.S.C. 446(b). In *McQuatters*, the Tax Court concluded that this statute authorizes the agency to use aggregate estimates to determine the amount of an employee's unreported tip income for income tax purposes. See also *Cracchiola* v. *Commissioner*, 643 F.2d 1383 (9th Cir. 1981); *Mendelson* v. *Commissioner*, 305 F.2d 519 (7th Cir.), cert. denied, 371 U.S. 877 (1962); *Krause* v. *Commissioner*, 60 T.C.M. (CCH) 1430 (1990), aff'd without op., 944 F.2d 897 (3d Cir. 1991). As the court stated in *Palmer* v. *IRS*, 116 F.3d at 1312, "Congress specified no particular methods or evidentiary burdens on the Commissioner when choosing a method for reconstructing a taxpayer's income under Section 446. The Commissioner, therefore, has wide discretion in choosing an income-reconstruction method."

The principle adopted by the Tax Court in *McQuatters*, however, has a far broader foundation. Even apart from the situations involving improper tax accounting methods to which Section 446(b) applies, courts have routinely approved the use of reasonable estimates in determining items of unreported income for income tax purposes simply as a reasonable method of determining a disputed factual issue. See, *e.g.*, *Anaya* v. *Commissioner*, 983 F.2d 186 (10th Cir. 1993); *Dodge* v. *Commissioner*, 981 F.2d 350 (8th Cir. 1992); *Erickson* v. *Commissioner*, 937 F.2d 1548 (10th Cir. 1991); *Polland* v. *Commissioner*, 786 F.2d 1063 (11th Cir. 1986) *Delaney* v. *Commissioner*, 743 F.2d 670 (9th Cir. 1984); *Gerardo* v. *Commissioner*, 552 F.2d 549 (3d Cir. 1977); *Mitchell* v. *Commissioner*, 416 F.2d 101 (7th Cir. 1969), cert. denied, 396 U.S. 1060 (1970); *Ehlers* v. *Vinal*, 382 F.2d at 63. See also *United States* v. *Janis*, 428 U.S. at 437, 441 (describing the calculation of a

wagering excise tax assessment based on a reasonable estimate of wagers made); *Carson* v. *United States*, 560 F.2d 693, 698-700 (5th Cir. 1977) (upholding a wagering excise tax assessment based on a reasonable estimate of total wagers accepted by a bookmaker during the relevant period); *DiMauro* v. *United States*, 706 F.2d 882, 885 (8th Cir. 1983) (same); *Collins* v. *Daly*, 437 F.2d 736, 737-738 (7th Cir. 1971) (describing wagering excise and special occupational tax assessments based on estimates). The government's reasonable aggregate estimate of tip income constitutes relevant evidence in tax litigation, for it tends "to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Fed. R. Evid. 401. As the court emphasized in *Dodge* v. *Commissioner*, 981 F.2d at 353, an "assessment is intended to be an estimate. It is expected to be rational not flawless." The conclusion of the majority in this case that the Service lacks authority to make aggregate estimates of items of income in assessing taxes thus departs from the long-established rule to the contrary.

b. Section 446(b) of the Internal Revenue Code, which was cited by the Tax Court in *McQuatters*, applies only to the correction of improper methods of accounting employed in determining the "income" of the taxpayer and therefore arguably has no direct application to this employment tax case. Pet. App. 10a. While other courts have nonetheless found that provision "'informative' in concluding that the IRS is authorized to construct its assessment by means of estimation" (*ibid.* (quoting *Bubble Room, Inc.* v. *United States*, 159 F.3d at 566)), the court of appeals in the present case sought to draw a different conclusion. The court stated that the fact that Section 446(b) does not

apply directly to employment tax cases suggests that Congress intended to *limit* the Service's use of estimates in employment tax cases, for "Congress obviously knew how to give the IRS the authority to use estimation in lieu of actual calculations, and just as clearly thought it necessary to say so explicitly when it wished to confer that power." Pet. App. 10a.

That reasoning is erroneous on its own premise, however, for Section 446(b) plainly does *not* "explicitly" say anything about using estimates. It merely authorizes the Treasury to require methods of accounting that "clearly reflect income." 26 U.S.C. 446(b). Nothing in this statutory text reveals any intention of Congress to preclude the use of methods of estimation in tax calculations in *any* circumstance. As the Eleventh Circuit correctly concluded in *Morrison Restaurants*, 118 F.3d at 1529-1530, "[g]iven the structure of the Internal Revenue Code, we are unconvinced that Congress's silence can be construed to mean that an employer cannot be assessed its share of FICA taxes based on employees' unreported tips in the aggregate without determining the underreporting by the individual employees."

c. In her dissent in this case, Judge McKeown correctly identified the source of the agency's general authority to use estimates in making FICA tax assessments. Section 6201 broadly authorizes the Secretary to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title." 26 U.S.C. 6201. In making tax assessments under the Internal Revenue Code (including FICA tax assessments), Congress has thus left it "up to the IRS to choose the method [to determine the amount of taxes], so long as reasonable." Pet. App. 26a. See, *e.g.*, *Anaya* v. *Commissioner*, 983 F.2d at 188; *Dodge* v. *Commis-*

sioner, 981 F.2d at 353; cases cited pages 21-22, *supra*. As the Federal Circuit concluded in rejecting the contentions that were endorsed by the majority below in this case, "[26 U.S.C.] 6201 implicitly authorizes the IRS to use an indirect formula" because "the IRS would have to use an indirect formula to estimate the amount of FICA tax owed by an employer when there is no other way to 'determine and assess' the wages deemed to have been paid by the employer." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565. While the panel in the present case acknowledged that its decision conflicts with the decision of the Federal Circuit in *Bubble Room* (Pet. App. 12a, 13a n.9, 14a), the panel gave no consideration to the relevance of Section 6201 to this case.

d. The fact that reasonable, aggregate estimates may properly be employed in determining the employer's FICA tax liability is especially apparent in view of the fact that Section 3121(q) authorizes the IRS to issue a demand for payment of such taxes even when the statements given by employees to the employer are "inaccurate or incomplete." 26 U.S.C. 3121(q). In such circumstances—where accurate and complete records showing the amount of tips do not exist—the IRS has no plausible alternative but to rely on an indirect method to estimate the tips. In resolving factual questions concerning the amount of unreported tips, other courts of appeals have thus unanimously concluded that "the IRS may base assessments on indirect formulas in circumstances where it is clear that the taxpayer has understated the amount of wages received and it is impossible or impractical to determine the exact amount of wages actually received." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 566. See *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d 990,

996-997 (7th Cir. 2000); *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530.

Moreover, the majority's conclusion that an estimate of the employer's FICA tax liability is impermissible, and that what is required is an "employee-by-employee determination of the taxable tips each has earned" (Pet. App. 13a), suffers from an obvious internal contradiction. If the IRS were to audit each employee to determine the factual question of the amount of tips each employee earned, those individual determinations would themselves necessarily be based on estimates. See *McQuatters* v. *Commissioner*, 32 T.C.M. (CCH) at 1125 (describing method used by IRS to estimate the amount of tips received by individual employees).[17] It is obvious that any cash tips that are not reported on the credit charge slips retained by the employer cannot be traced and determined with precision. A method of estimation based on the average tip rate and the gross sales of the restaurant is far more likely to achieve factual accuracy than the individual audits suggested by the court of appeals. In any event, the court's suggestion that adding up the results of individual audits would make the estimation of tip income unnecessary is clearly incorrect—the sum of individual audits would simply be the sum of individual estimates of tip income.

4. a. The district court erroneously concluded (Pet. App. 47a-48a) that 26 U.S.C. 45B supports the view that assessments of the employer's FICA tax on unreported tips must be based upon a determination of individual employee earnings. Pet. App. 47a-48a.

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[17] See also *Cracchiola* v. *Commissioner*, 643 F.2d at 1385 (same); *Mendelson* v. *Commissioner*, 305 F.2d at 521-522 (same); *Krause* v. *Commissioner*, 60 T.C.M. (CCH) at 1431 (same).

Section 45B was added to the Internal Revenue Code by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13443(a), 107 Stat. 568. This statute generally allows an income tax credit to an employer for employer FICA taxes paid with respect to employee tips. The amount of the credit equals an employer's FICA tax payments attributable to tips in excess of those treated as wages for the minimum wage requirements of the Fair Labor Standards Act. 26 U.S.C. 45B(a), (b). The Fair Labor Standards Act allows an employer to pay less than the minimum wage directly to a tipped employee, by treating tips received by the employee as satisfying a portion of the statutory minimum wage. 29 U.S.C. 203(m); see *Kilgore* v. *Outback Steakhouse*, 160 F.3d 294, 298 (6th Cir. 1998); 29 C.F.R. 531.59.[18] Nothing in the text of this statute has any relevance to the issues addressed in this case, and the history of the statute also provides no indication that it is intended either to alter or inform the meaning of Section 3121(q). See H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 736-737 (1993).

The district court reasoned, however, that Section 45B indicates that individual employee determinations of tip income must be made so that the amount of the credit to which the employer is entitled under that statute may be determined. Pet. App. 47a-48a. The court's conclusion that "[a]n employer cannot take advantage of this tax credit [under Section 45B] if the IRS assesses his FICA taxes on unreported employee tips in the aggregate" (*id.* at 47a) is, however, simply wrong. The Section 45B credit is available for employer FICA taxes on *all* employee tips *except* those that

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[18] The statutory minimum wage is set forth in 29 U.S.C. 206(a)(1).

are applied (under 29 U.S.C. 203(m)) to satisfy the employer's minimum wage obligation. 26 U.S.C. 45B(b)(1)(B). If the employer is paying its employees the minimum wage (or more), all tips included in the aggregate assessment of the employer's FICA taxes are eligible for the Section 45B credit. On the other hand, if the employer is paying less than the minimum wage, and using tips to bring an employee's wage up to the minimum wage, then the employer will know the amount of tips that are being used to satisfy the minimum wage requirement—for that is simply the difference between the minimum wage and the amount the employer is actually paying. In both situations, the employer therefore knows the amount of tips that are eligible for the Section 45B credit. The district court therefore erred in suggesting that the Section 45B credit "would become a nullity for many employers" if "the IRS were permitted to make assessments of taxes due on an aggregation of unreported tips" (Pet. App. 48a).[19]

b. The district court similarly erred in concluding (Pet. App. 49a-50a) that a 1996 amendment to Section 45B is relevant to this case. A Treasury Regulation promulgated in 1993 had provided that the tax credit provided by that statute is available only for taxes paid with respect to the tips reported by the employee to the employer under Section 6053(a). 26 C.F.R. 1.45B-1T. The Treasury believed that this interpretation of

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[19] The court's reliance on Section 45B to interpret Section 3121(q) involves a temporal as well as a logical flaw. Section 45B was enacted in 1993, six years after the amendment of Section 3121(q) in 1987, and two years after the first of the two tax years involved in this case (1991 and 1992). Section 45B was thus not a part of the law, and does not inform the meaning of the law, for the years in issue in this case.

Section 45B "provides employers with a strong incentive for encouraging employees to report their tips." Pet. App. 50a (quoting Letter from Leslie B. Samuels, Assistant Secretary of Treasury, to Senator Trent Lott (Mar. 30, 1994)). In 1996, however, Congress amended Section 45B to clarify that the credit is available with respect to employer FICA taxes paid on *all* tips, "without regard to whether such tips are reported under section 6053." 26 U.S.C. 45B(b)(1)(A)), as amended by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1759.

The district court suggested that this 1996 amendment of Section 45B shows that Congress has no interest in providing employers an incentive to encourage employee tip reporting. Pet. App. 50a. In fact, however, what this amendment demonstrates is that Congress wished to provide the credit of Section 45B for the taxes *actually* paid by the employer even if the employees did not separately report and pay their share of FICA taxes on tips. That legislative determination is consistent with, not opposed to, the government's position in this case—for the government's position is that employers are required to pay the correct amount of employer FICA taxes they owe on tip income even if their employees fail properly to report and pay taxes on that income.

Nothing in Section 45B or its 1996 amendment suggests that Congress desired to "provide an incentive to an employer to discourage accurate reporting or to ignore clearly inaccurate reporting by its employees." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567. By contrast, "basing the employer's share of FICA taxes exclusively on employees' reported tips *would* provide incentive to the employer to discourage accurate reporting or ignore blatantly incorrect reporting

by the employees so that the employer could pay less FICA tax." *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530 (emphasis added).

c. Unlike the district court, the court of appeals did not attempt to rely directly on the 1996 amendment to 26 U.S.C. 45B. The court nonetheless reasoned that this legislation "demonstrates the difficulty the executive and the legislative branches have had in reaching common ground on the problem of collecting taxes on employee tips" and thereby supports a conclusion that the Treasury "must obtain authorization directly from Congress" to use estimates in determining employer FICA taxes. Pet. App. 17a.

Neither the text of the amendment nor the Committee Reports that preceded its enactment, however, say anything about Section 3121(q) or about assessments of employer FICA taxes on unreported tips. See H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 186-187 (1996); S. Rep. No. 281, 104th Cong., 2d Sess. 7-8 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 5-6 (1996). And, in reaching its unsupported conclusion, the court of appeals did not consider or address other contemporary legislation that in fact *has* addressed the assessment of the employer FICA tax on tip income.

In particular, in 1998, in response to restaurant industry complaints about the IRS practice of assessing an employer's liability for FICA taxes based on aggregate tip income (and the decision of the Eleventh Circuit in *Morrison Restaurants* approving of that practice), Congress elected *not* to prohibit the IRS from following that practice. Instead, Congress enacted a statute that provides that IRS employees "may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering a Tip Reporting Alternative Commitment [TRAC] Agreement." Internal Revenue

Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 755. A restaurant that signs a TRAC agreement with the IRS agrees to educate its employees about tax reporting, establish procedures to ensure accurate tip reporting, and fulfill various federal tax requirements. In return, the IRS agrees to base the restaurant's FICA tax liability solely on reported tips and any unreported tips discovered during an IRS audit of an employee. See H.R. Conf. Rep. No. 599, 105th Cong., 2d Sess. 274-275 (1998); S. Rep. No. 174, 105th Cong., 2d Sess. 75 (1998); H.R. Rep. No. 364, 105th Cong., 2d Sess. Pt. 1, at 8-9 (1998).

As the dissent in this case correctly observed, this 1998 statute reflects the understanding of Congress that, in the absence of such a TRAC agreement, the IRS has full authority to make aggregate assessments against employers without making determinations with respect to individual employees. Pet. App. 28a. As Judge McKeown correctly concluded, when Congress enacted the 1998 law, it necessarily "*acknowledged the IRS's power to make aggregate calculations* of employer tax obligations, before or without making determinations with respect to individual employees." Pet. App. 28a. Accord, *330 West Hubbard Restaurant Corp.* v. *United States*, 37 F. Supp.2d 1050, 1055 (N.D. Ill. 1998), aff'd, 203 F.3d 990 (7th Cir. 2000).[20]

4. The court of appeals also erred in suggesting (Pet. App. 15a-16a) that 26 U.S.C. 6205(a)(1) provides a fur-

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[20] If, as the court of appeals held in this case, the Service lacks authority to determine employer FICA taxes on unreported tips without first determining the amount of the individual employees' tips, "it would make no sense for a restaurant to enter into a TRAC agreement in return for the Service's agreement not to do that which it lacks authority to do." *330 West Hubbard Restaurant Corp.* v. *United States*, 37 F. Supp.2d at 1055-1056.

ther basis for its conclusion in this case. That statute provides that, when an incorrect amount of FICA taxes is paid by an employer, the employer may be allowed to correct its return and pay the proper amount "without interest, in such manner and at such times as the Secretary may by regulations prescribe." 26 U.S.C. 6205(a)(1). The court stated, without analysis or explanation, that this statute "seems to authorize the Secretary to give the IRS authority to make assessments based on aggregate estimates," but only "by promulgating a regulation to that effect." Pet. App. 15a-16a.

The court's unexplained conclusion is incorrect. Section 6205(a)(1) and its regulations encourage accurate reporting of FICA tax obligations by establishing procedures that permit employers, in limited circumstances, to report underpayments of FICA taxes without incurring interest obligations. See 26 C.F.R. 31.6205-1. An underpayment cannot qualify for interest-free treatment under those provisions, however, *after* an assessment of the tax has been made. See 26 C.F.R. 31.6205-1(a)(6). Respondent has not claimed that it came forward with any timely report of an underpayment of tax or is otherwise entitled to the benefits of this provision. Section 6205 and its regulations thus simply have no application to this case.[21]

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[21] Moreover, the question in this case is not whether the Treasury *could* issue a regulation that specifies that aggregate estimates may be used in determining employer FICA tax liability. Instead, the question presented is whether the general authority conferred on the Service to make determinations and assessments of taxes (26 U.S.C. 6201) permits the use of aggregate estimates of unreported tips that respondent concedes are both reasonable and factually based. See note 8, *supra*. The broad authority provided to the Secretary to prescribe rules and regulations for the enforcement of the Internal Revenue Code "does *not* require the promul-

III. THE IRS IS NOT REQUIRED TO CREDIT THE SOCIAL SECURITY EARNINGS RECORDS OF INDIVIDUAL EMPLOYEES AS A PREREQUISITE TO AN ASSESSMENT OF EMPLOYER FICA TAXES

The district court indicated that an aggregate FICA tax assessment against the employer would be improper because such a tax could not be "credited to the employees' Social Security accounts" and thus would not result in an increase in the employee's benefits. Pet. App. 45a. No provision in the Internal Revenue Code or the Social Security Act, however, links the imposition of the employer FICA tax to the crediting of employees' individual Social Security accounts. To the contrary, it is well established that the amount of Social Security benefits earned by an employee does "not in any true sense depend on contribution to the program through the payment of taxes, but rather on the earnings record of the primary beneficiary." *Flemming* v. *Nestor*, 363 U.S. 603, 609 (1960). See also *Calderon* v. *Witvoet*, 999 F.2d 1101, 1106 (7th Cir. 1993) (employee is entitled to Social Security credit for all sums earned, whether or not employer actually pays its FICA tax obligations). Accordingly, "nothing in the [Social Security] Act justifies the argument that a tax is due only when a corresponding benefit will flow to the taxpayer or his survivors. * * * [T]he liability for the tax is not under the Act made to depend in any way upon the assurance that the taxpayer's benefit will be thereby increased." *Whitaker* v. *United States*, 194 F. Supp.

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gation of regulations as a prerequisite to the enforcement of each and every provision of the Code." *United States* v. *Langert*, 902 F.Supp. 999, 1003 (D. Minn 1995); see *Granse* v. *United States*, 892 F.Supp. 219, 224-225 (D. Minn. 1995).

505, 507 (D. Mass.), aff'd per curiam, 295 F.2d 817 (1st Cir. 1961).

Moreover, the Social Security earnings record of an individual worker is based upon wages earned and reported, not on taxes paid. 42 U.S.C. 405(c)(2)(A). An employee is required to report his tips to the employer. 26 U.S.C. 6053(a). The employer, in turn, reports the amount of wages paid to the employee (including tips received) on Form W-2, and those amounts are then used by the Social Security Administration to compile earnings records. Tips that are not reported to the employer by the employee nonetheless must be reported to the IRS by the employee on IRS Form 4137 (Social Security and Medicare Tax on Unreported Tips), and the employee is required to pay the employee share of FICA taxes with respect to those tips. See Rev. Rul. 95-7, 1995-1 C.B. 185 (Q&A 6). As this reporting Form states, "The amounts you report below are for your social security record. This record is used to figure any benefits, based on your earnings, payable to you and your dependents or your survivors. Fill in each item accurately and completely."[22] Employees thus receive Social Security earnings credit for tips that are reported either (i) in statements they submit to their employer pursuant to 26 U.S.C. 6053(a) or (ii) in statements they submit to the IRS on Form 4137. See *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530. An employee fails to receive Social Security credit for tips earned only if he fails to report his earnings, as required by law. See *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996; *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565;

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[22] Form 4137 can be found in IRS Pub. 1132, *Reproducible Copies of Federal Tax Forms and Instructions* 321-322 (2000).

Morrison Restaurants, Inc. v. *United States*, 118 F.3d at 1530. Whether the employee is liable for, or pays, taxes due on the total amount of tips he receives is not determinative of the amount of benefits to which he is entitled under the FICA provisions.[23]

IV. THE COURT OF APPEALS ERRED IN RELYING ON ASSERTED FLAWS IN THE CALCULATION OF THE ASSESSMENT IN THIS CASE

1. The court of appeals also erred in concluding that the aggregate estimate of tips made by the IRS in this case has "some serious flaws." Pet. App. 8a. The dissent aptly observed that the majority "confuses the IRS's authority to use the aggregate method with the accuracy of that method." *Id.* at 32a. "[W]hether there are flaws in the indirect formula used to estimate the FICA tax is a separate matter from whether the IRS has the authority to assess an employer-only FICA tax based on an aggregate estimate of unreported tip income." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 568. Accord, *330 West Hubbard Restaurant Corp.* v.

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[23] The district court's concern with Social Security benefits ignores the fact that one component of FICA taxes is the 1.45 percent Medicare tax of 26 U.S.C. 3111(b). See note 11, *supra*. Although the amount of an employee's Social Security benefits will be affected by the employee's reported earnings, all individuals entitled to Medicare are entitled to the full range of Medicare benefits. Entitlement to those benefits is based simply on a minimum number of quarters of coverage. See H.R. Rep. No. 241, 99th Cong., 2d Sess. Pt. 1, at 25-26 (1986); 42 U.S.C. 413, 414, 426. The wages and reported tips received by respondent's employees gave them quarters of coverage. The unreported tips (and the employer share of the Medicare tax on those unreported tips) would have no effect on their Medicare benefits even if the IRS made the individual determinations required by the court of appeals.

United States, 203 F.3d at 996. Indeed, it is well-settled that proof that the amount of an assessment is incorrect does not invalidate the entire assessment. *United States* v. *Schroeder*, 900 F.2d 1144, 1148 (7th Cir. 1990). Instead, "[w]hen a court is faced with an incorrect but otherwise valid assessment, the proper course is not to void the assessment * * * but to determine what, if anything, the taxpayer owes the government." *Ibid.* See also *Lewis* v. *Reynolds*, 284 U.S. at 283; *Burns* v. *United States*, 974 F.2d 1064, 1066 (9th Cir. 1992).[24]

2. Moreover, there is no evidence to support the majority's conclusion that "flaws" exist in the agency's aggregate estimate of tips.[25] The majority first suggested that "the IRS's method for estimating cash tips likely overstates the amount of such tips received" (Pet App. 8a) because "experience shows that charged tips generally exceed cash tips" (*id.* at 4a). There is simply no evidence in the record of this case to support the court's factual assertion that "experience" reveals that the charge tip rate at respondent's restaurant

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[24] "Even if the formula overestimated tip income, the court should have modified it, not rejected it. An assessment that is too high should be reduced, but is not wholly invalid." Note, *Assessing Employer FICA Tax on the Estimated Aggregate Unreported Tips of Employees*, 53 Tax Law. 781, 788 (2000). "The court should have tried the case and determined the correct assessment instead of rejecting it completely." *Ibid.*

[25] The suggestion of the court of appeals that there are "flaws" in the aggregate estimate of tips in this case is particularly inappropriate since respondent has not itself challenged the reasonableness or accuracy of the agency's estimate. See Pet. App. 33a. Respondent relied solely on its assertion that the IRS lacked authority to make an aggregate estimate in determining the employer portion of the FICA tax on tips. See *id.* at 33a, 36a.

exceeded the cash tip rate at that restaurant. See note 25, *supra*.

Similarly, the majority erred in stating that, "as to credit card tips, the IRS method fails to take into account the three percent fee imposed by the credit card companies which may be passed on to employees by the restaurant." Pet. App. 8a-9a. There is again no evidence in the record—or even any assertion by the taxpayer—that this procedure was in effect at respondent's restaurant. The asserted "flaw" identified by the court of appeals is thus solely one of its own conjecture and is not grounded in the record of this case.

Finally, the court stated that "the estimate [does not] make allowance for the statutory wages bands which limit the restaurant's FICA tax liability." Pet. App. 9a; see note 1, *supra*. But there is again no evidence in this case that any of respondent's employees earned less than $20 in tips in any month; nor is there any evidence that any of its employees received tips plus salary in excess of the Social Security wage base. In the absence of evidence that some of the unreported tips fell outside the wages band, the court's suggestion that the failure to account for the such amounts is a "flaw" in the tip estimate is mere speculation. In any event, the theoretical possibility that some minor portion of the tips received might fall outside the wages band would not invalidate the entire assessment.[26] A failure to take the

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[26] The effect of this theoretical possibility would be marginal. For example, if an employee happened to work only one day during a month, earned less than $20 that day, and repeated this practice on five occasions during the year, then the IRS's determination of the total amount of tips, would be $100 too high. The assessment of FICA taxes on that amount, at a rate of 7.65%, would in turn be $7.65 too high. If respondent were concerned that its taxes were too high on this factual rationale, it could have challenged the

"wages band" into account does not "make the assessment unlawful;" it would "merely suggest[] that the amount of FICA tax assessed against [the employer] may have been incorrect by some margin and that it may be entitled to a refund of some portion of the FICA tax assessed against it." *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567; accord, *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996. It is the employer's obligation to establish the amount by which the assessment is incorrect, and the employer expressly declined to mount such a challenge in this case. See notes 24-26, *supra*.

3. The majority expressed concern that an aggregate estimate of unreported tip income "puts an impossible burden on [the taxpayer], making the already heavy presumption that attaches to an IRS assessment virtually conclusive." Pet. App. 8a.[27] That concern,

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amount of taxes that it owed on such a basis. Instead, however, respondent did not dispute the reasonableness of the estimate (Pet. App. 33a), did not raise any factual challenge to the estimate, and instead stipulated that it "does not dispute the facts, estimates and/or determinations used by IRS as a basis for its calculation of an amount of aggregate unreported tip income by all directly and indirectly tipped employees of the taxpayer collectively." J.A. 35.

[27] The court of appeals incorrectly stated that determining the employer's FICA liability by using an estimate amounts to "forcing the employer to pay the price for its employees' dereliction." Pet. App. 14a. All that the employer is required to pay is the employer FICA tax imposed on it by 26 U.S.C. 3111. That statute requires employers to pay FICA taxes on the total amount of tips and other remuneration, up to the Social Security wage base. The possibility that employees may fail to pay the proper taxes due on part of their tips does not excuse respondent from paying the proper taxes on those tips. "You can't resist the payment of taxes on the ground that someone else isn't being made to

however, is belied by the proceedings in the *Bubble Room* and *Morrison Restaurants* cases. The employer in *Bubble Room* pointed to several purported defects in the methodology employed by the IRS in calculating the assessment. The court concluded that there were genuine issues of material fact that made summary judgment on the *amount* of the employer's liability inappropriate. 159 F.3d at 567. The case was remanded to the district court for those factual issues to be addressed. *Ibid.* And, in *Morrison Restaurants*, based on information provided to the IRS by the restaurant and its employees, the IRS made its determination of unreported tips using a cash tip rate that was lower than the rate originally proposed by the IRS. *Morrison Restaurants, Inc.* v. *United States*, 918 F. Supp. 1506, 1513 (S.D. Ala. 1996), rev'd on other grounds, 118 F.3d 1526 (11th Cir. 1997).[28]

As correctly observed by Judge McKeown in her dissenting opinion in this case, "the aggregate method is predicated on a reasonable estimate and that may be

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pay his fair share." *Buchanan* v. *United States*, 87 F.3d 197, 202 (7th Cir.), cert. denied, 519 U.S. 950 (1996).

[28] The suggestion of the court of appeals that the restaurant "is not in an inherently better position than the IRS to determine what its employees actually earned in tips" (Pet. App. 8a) is wide of the mark. The restaurant has daily contact with, and information about, its employees that the IRS does not have. The restaurant has charge slips showing the amount of charged tips received by each of its employees. The restaurant also has records showing how many days, and how many hours each day, each employee worked during the year. The restaurant, for example, is clearly in a better position than the IRS to determine if any of the tip income fell outside of the "wages band." See note 1, *supra*. In any event, the IRS is authorized to make an assessment of tax in every case (26 U.S.C. 6201), and the existence of this power is not dependent on whether the taxpayer keeps, or fails to keep, adequate records.

challenged by the taxpayer." Pet. App. 33a. In this case, however, respondent chose not to raise any argument about the correct amount of its liability in the proceedings below. As the dissent emphasized, "the issue of accuracy is [thus] not before us, because [respondent] did not challenge the accuracy of the calculation—it challenged only the IRS's authority to assess the taxes under the aggregate method." *Ibid.*

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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UNITED STATES OF AMERICA,

Petitioner,

v.

FIOR D'ITALIA, INC.,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

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QUESTION PRESENTED

Whether Congress has conferred upon IRS the authority to base employer FICA taxes on an inherently inaccurate aggregate estimate of total tips received by all employees collectively, and thus shift to the employer the burden of proving the actual taxable tips, which it has no way of ascertaining.

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STATEMENT

This case involves the issuance of a Notice and Demand by the Internal Revenue Service ("IRS") to Fior D'Italia ("Fior") for Federal Insurance Contribution Act ("FICA") taxes on tip income which employees allegedly received but failed to report to Fior. The additional FICA taxes in the Notice and Demand were based on an estimation of gross tips received by all of Fior's employees collectively, rather than a determination of the tip earnings of Fior's individual employees. Fior challenged the assessment, contending Congress did not impose, and IRS is not authorized to assess, FICA taxes on employers based on an aggregate estimate of the collective tip income of all employees. Instead, Fior contends the tax must be based on a determination of the tip earnings of individual employees. Both the district court and the court of appeals agreed, with the appellate court ultimately holding that "there is no way to determine the employer's FICA tax liability without making an employee-by-employee determination of the taxable tips each has earned." Pet. App. 13a, 51a.

Three circuit courts which have considered this issue, as well as the dissent below, have opined otherwise. However, these opinions are based entirely upon the faulty premise that *Chevron* deference is owed to IRS even in the absence of any articulation by IRS of its interpretation of the statutory provisions. Pet. App. 23a-30a. This court's opinion last term in *United States v. Mead*, 533 U.S. 218 (2001), holds otherwise.

Background. The collection of taxes on tip income presents a serious administrative difficulty for the IRS.

For more than 50 years, Congress and IRS have been grappling with the problem. Under state and federal labor and common law, tips are the sole and exclusive property of the employee. *Williams v. Jacksonville Terminal Co.*, 315 U.S. 386, 397 (1942). Since tips are paid by customers directly to employees, and shared among employees in varying unknown amounts, Congress has repeatedly and consistently refused to permit the employer to become involved in the tipping transaction or to hold the employer responsible for the accounting of tip income. Instead, Congress has placed the responsibility for reporting tip income squarely on tipped employees. In turn, Congress has armed the IRS with the power and means to investigate employee underreporting of tip income and to enforce accurate reporting by employees.

IRS is not happy with the arrangement, however, and has continually attempted to shift its own burden of determining unreported tip income to the employers of tipped employees on the basis of a misconception that the restaurant is "in an inherently better position than the IRS to determine what its employees actually earned in tips." (Gov. Br. "G.B." 38) This fundamental disagreement between Congress and IRS has led to numerous clashes, manifested in the history of the relevant statutes.

Although tips have long been subject to income taxes, since they were not paid by the employer, for many years, they were not considered "wages" for FICA purposes. Initially the employer had no responsibility for the collection and withholding of taxes on tips received. Congress, Treasury, and the Department of Labor all recognized that "tips are an extremely unique type of income."

S. Rep. No. 404, 89th Cong., 1st Sess. (1965), 1965-2 C.B. 758. They recognized that tips are a gratuity payment made directly to one who serves him, the amount of which, if any is determined solely by the customer, and that tips are often split among employees in various tip splitting or pooling arrangements. *See* Rev. Rul. 59-252, 1959-2 C.B. 215; 29 C.F.R. § 531.52; H.R. Rep. No. 213, 89th Cong., 1st Sess. (1965), 1965-2 C.B. 749.

But in 1964, at the request of restaurant employers and employee unions, Congress "recognize[d] that more than a million employees now covered by the social security program have an important part of their income from work excluded from coverage because it is received in the form of tips, and that as a consequence such employees do not have adequate protection under social security." S. Rep. No. 404, *supra*. *See also* H.R. Rep. No. 213, *supra* ("Coverage of tips will provide better protection under the social security program for more than a million employees and their dependents."). Congress "concluded that it would be appropriate . . . to count tips toward benefits" and therefore subjected tips to the *employee* share only of the FICA tax in order to give employees social security credit for their tip wages. *See* P.L. 89-97 § 313(c) (effective 1965).

However, since tips were not a payment from the employer to the employee but a payment from an independent third party to the employee, the employer was not charged an employer share of FICA tax on the tips at that time. This exclusion of tips from the definition of "wages" for purposes of the employer FICA tax remained

in effect for nearly 25 years until the amendments to 26 U.S.C. 3121(q), here in issue.[1]

At the time Congress made the decision to count tip income for social security benefit purposes, Congress recognized that tips presented a unique problem because they were not paid by the employer, were the exclusive property of the employee, and were often not reported by employees for income tax purposes. Congress realized that "only a small fraction" of tip income was actually reported, and attempted to "devise a fair and practical system for obtaining information on amounts of tips received by an individual which could serve as a basis for contributions and benefit credits." H.R. Rep. No. 213. Congress "decided that the only equitable way of counting tips towards benefits is on the basis of actual amounts of tips received and that the only practical way to get this information is to require employees to report their tips to the employer." *Id.*[2]

Accordingly, Congress limited the employer's responsibility for and involvement with respect to tip income to an obligation to withhold under 26 U.S.C. 3101,

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[1] In 1977, Congress did change the law to require employers to pay FICA taxes on tips to the extent they were used to offset an employer's minimum wage obligations. Social Security Amendments of 1977, Pub. L. No. 95-216, § 315(a), 91 Stat. 1509, 1536, repealed by Pub. L. No. 100-203, Title IX, § 9006(b)(2), 101 Stat. 1330-289 (1987). H.R. Rep. No. 95-702, 95th Cong., 1st Sess. 11 (1977), reprinted in 1977 U.S.C.C.A.N. 4155, 4168.

[2] This decision was coupled with the enactment of a penalty equal to 50% of the taxes due if the employee fails to report his tips to the employer. *See* 26 U.S.C. 6652(b).

et seq., and 26 U.S.C. 3401, et seq., exclusively on the basis of reports of tip income filed by employees with the employer pursuant to 26 U.S.C 6053(a). In turn, IRS was charged with the responsibility for enforcing the accuracy of such reporting. Ever since, IRS has attempted to construe the law otherwise.

IRS's first attempt to shift to employers its responsibility for monitoring, verifying and effectively enforcing the law was to read into the employee reporting provisions of Section 6053(a) a requirement that the employer audit and verify the accuracy of the amounts reported by employees to employers on Form 4070. In response, the District Court in *Norfolk Yacht and Country Club v. United States*, 75-2 USTC 9849 (E.D. Va., 1975), held:

> The United States may feel that all employees may not accurately report their monthly tip receipts to employers, but it is incorrect in assuming that the employer has any duty to insure that the amount actually reported is true and accurate. The United States would have plaintiff be its watchdog and that is not contemplated within section 6053. The employer is not ultimately responsible for accuracy, but the employee himself is, as is reflected in 26 U.S.C. § 6652(c). If the United States is concerned with dishonest taxpayers it has the means to investigate them; but the investigative burden should not be shifted to the withholding employer in the absence of Congressional intent to do so. *The court finds that the plaintiff's sole method of reporting, for FICA and withholding tax purposes, is by*

> *use of Form 4070 and that such method is all that is required of plaintiff as a matter of law.*

Id. (emphasis added).

A year later, purporting to act under Section 6041(a), IRS issued a series of Revenue Rulings which would have obligated employers to include on each W-2 issued to an employee all charged tips turned over to that employee. Rev. Rul. 75-400, 1975-2 C.B. 464 and 76-231, 1976-1 C.B. 378. Employers protested that IRS failed to consider the fact that employees are required under the law to report only what they retain after tipping out and that the charged tip amounts could well be in excess of that amount. *See* Reg. 31.3121(q)-1(c). They also argued that many employers do not track credit card sales by employee and no employers track credit card tips after tip outs by employee. This outcry was met with sympathy from Congress in the form of legislation prohibiting enforcement of IRS's proposed revenue rulings.

Congress provided that Section 6041(a) "shall be administered . . . without regard to Revenue Rulings 75-400 and 76-231, and . . . in accordance with the manner in which such law was administered before the issuance of such rulings." Tax Reform Act of 1976, P.L. 94-455, § 2111(a) (effective Jan. 1, 1976). Congress subsequently codified Section 6041(e) to clarify that the reporting requirements of that section had no applicability to tips and amended Section 6001 to clarify that the only records that the employer is required to keep with respect to tips are total credit card receipts and the employees' reports of tips to the employer pursuant to Section 6053. P.L. 95-600 § 501(b). *See* Reg. 31.6001-5(a)(16).

Congress, however, did not turn a deaf ear to IRS's concerns. In 1982, Congress enacted the tip allocation provisions of Section 6053(c), which provided IRS with more information with respect to tip income than virtually any other form of income. Tax Equity and Fiscal Responsibility Act "TEFRA," P.L. 97-248 § 314(a). Specifically, when all employees in a restaurant fail to report collectively at least 8% of food and beverage sales as tips, Section 6053(c) requires the employer to report the aggregate shortfall to IRS and to allocate the shortfall among the directly tipped employees in the proportion that each employee's sales or hours worked bears to total sales of the establishment or total hours worked by all such employees. This allocation is also required to be reported on each employee's W-2 form. The allocated tips *must* be reported on the employee's income tax return unless he has a daily record which will establish that the allocated tips were not earned. IRS Publication 531.

In addition, Section 6053(c) requires restaurants to annually file Form 8027, informing IRS of the restaurant's gross receipts, aggregate amount of charge receipts, aggregate amount of charged tips shown on the receipts, and total tips reported by the employees. *See* J.A. pp. 38-39. Once again, however, Congress refused to require the employer to be involved in ascertaining the veracity of employee tip reporting. Section 6053(c) did not shift the responsibilities for reporting from the employee to the employer; nor did it shift the responsibility for monitoring, auditing, and enforcing employee compliance from the IRS to the employer. Rather, the provision was enacted "in order to assist the [IRS] in its examination of returns filed by tipped employees," and the employer's

responsibility was limited to the provision of information for purposes of assisting IRS in doing its job. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 556-8, reprinted in 1982 U.S.C.C.A.N. 1328-30.

When Congress enacted the tip allocation provisions, it also required the Treasury to conduct a study on tip compliance in the industry. TEFRA sec. 314(c). When the study was finally released in late 1990, the Treasury recommended that (1) the allocations threshold be increased to 10% of gross receipts; (2) employers be required to verify that employees report as income all tips they receive on credit card charges; and (3) the allocation provisions be extended to small establishments. None of these proposals was enacted by Congress. Research Division, Internal Revenue Service, Pub. 1530, *Tip Income Study: A Study of Tipping Practices in the Food Service Industry for 1984*, Catalogue No. 12482K, Study Conclusion p. i.

In 1987, in order "to apportion the costs of Social Security benefits more accurately," Congress amended Section 3121(q) to subject "all tips which are *credited for benefits purposes*" (rather than just those used to satisfy the employer's minimum wage obligations),[3] to the employer share of FICA.[4] IRS's interpretation of this

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[3] *See* Staff of Senate Committee on Finance, 100th Cong., 1st Sess., S. Prt. 100-63, Explanation of Provisions Approved by the Committee on December 3, 1987, for Inclusion in Leadership Deficit Reduction Amendment 203 (Comm. Print 1987) (emphasis added).

[4] *See* Omnibus Budget Reconciliation Act of 1987 (OBRA), Pub. L. No. 100-203, § 9006(a), 101 Stat. 1330, 1330-288 (effective

provision as permitting an assessment for an employer's share of FICA taxes based upon a determination of the tip income of all employees collectively is at the heart of much of the controversy in this case.

Commencing in 1993, six years after Section 3121(q) was enacted, IRS began threatening to assess the employer share of FICA taxes based on the gross estimated tips of all employees, without any determination of the employees' individual tip earnings, for each of the years since the amendment of Section 3121(q).[5] The threat of such an assessment effectively forces the employer into undertaking obligations for, verifying, investigating, monitoring, and policing compliance by its employees – responsibilities which Congress and the Courts have considered, evaluated, and steadfastly refused to transfer from IRS to the employer.

IRS presented restaurateurs with a Hobson's choice: potential assessment for employer FICA taxes on an aggregate estimate of unreported tips of all employees collectively, against which employers would have no defense in the absence of the necessary employee information as to actual tips received,[6] *or* participation in IRS's

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Jan. 1, 1988), amending 26 U.S.C. § 3121(q) (and repealing § 3121(t)).

[5] IRS's position is that the statute of limitations does not begin to run until a notice and demand is issued because not until that time is there a liability for the tax. *See* Pet. App. 11a, 12a, 42a, Rev. Rul. 95-7 1995-1 C.B. 482 and IRS Field Service Advice Memorandum 1998-468.

[6] This assessment could easily amount to twice a restaurant's annual profits. Industry profits are approximately

tip compliance program. The heart of the tip compliance program is the employer's "voluntary" cooperation in effectively forcing employees to report tips at an average aggregate percentage of sales through a Tip Rate Determination Agreement ("TRDA"). Although the Treasury Department had found that the nationwide average tip rate is 11.9% of gross sales and varies greatly, *see Tip Income Study*, p. 3, the IRS at a recent industry presentation disclosed that it is seeking to bring employee tip reporting up to 14½% of an establishment's gross sales.[7]

Under TRDA, the employer is responsible for enforcing reporting at the set rate by at least 75% of its tipped employees, monitoring continued reporting by its employees, and policing the filing of federal income tax returns by its employees. IRS agents have reportedly suggested that employers withhold paychecks of employees who refuse to participate, lock tips in a lock box until reported, or require servers to sign TRDA as a condition of employment in order to assure tip reporting at the IRS-determined rate.[8] In addition, the employer

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4% of sales (*See* brief of *Amicus* National Restaurant Association). An assessment for estimated unreported tips equal to 7% of sales for all years since 1988 would equal 7.5% of sales or nearly twice average annual profits (7% X 7.65% FICA X 14 years).

[7] Speech of Tony Worchalak, Director of the Office of Employment Tax Administration and Compliance for the Internal Revenue Service, before the American Payroll Association's Hospitality Payrolls Workshop, April 14-16, 1994.

[8] "The Tax Man," by John McLaughlin, *Restaurant Business Magazine*, October 10, 1994. It should be noted that many of these suggestions would violate various Federal and State Wage & Hour Laws.

must report to IRS the names, social security numbers, wages paid, shifts worked, hours worked, job classifications, and charged tips paid, as well as any other information deemed necessary by IRS. All this notwithstanding the fact that the employer is not legally required to maintain such information and regardless of whether the employer has a payroll information system for separating and identifying the information demanded by IRS. *See* brief of *Amicus* American Gaming Association ("AGA").

When the first few aggregate assessments were issued under TRDA, the industry docketed its first case in court and again turned to Congress for relief. In response, Congress enacted Section 45B in 1993. This provision allows employers to take a dollar-for-dollar income tax credit for FICA taxes paid with respect to employee tips in excess of those treated as wages for the minimum wage requirements.[9] The Section 45B credit had the effect of negating for many taxpayers the threat of the assessments here in issue.

Not easily deterred, less than 6 months after Congress enacted this strong rebuke to IRS's TRDA program, IRS promulgated a regulation limiting Section 45B's credit to taxes paid with respect to tips actually reported by the employee to the employer as required under Section 6053(a). Treas. Reg. § 1.45B-1T (26 C.F.R.). The Treasury reasoned that this restrictive interpretation of Section

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[9] *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13443(a), 107 Stat. 312, 568. *See also* Highlights and Documents, March 4, 1994 pp. 3913-3920 for a complete discussion of the purpose, intent, and history surrounding Congress's passage of 45B credit.

45B "provide[d] employers with a strong incentive for encouraging employees to report their tips." March 30, 1994 Letter from Assistant Treasury Secretary Samuels to Senator Lott.

Congress once again responded by countermanding IRS's action. Initially, 64 members of Congress, in a letter to Secretary of Treasury Lloyd Bentsen, made clear that the employer was not responsible for what the employee reports: "The IRS has cited 'Congressional intent' as the reason for restricting the FICA tax credit. This position has no basis in the statute or the conference report language." Highlights & Documents, March 4, 1994 at 3913. Congress ultimately followed up, in 1996, by codifying its disapproval of the Treasury's limitation on Section 45B's credit, thereby refusing to penalize employers if their employees failed to report all of their tips. Congress amended Section 45B to clarify that the credit is available with respect to employer FICA taxes paid on all tips, "without regard to whether such tips are reported under section 6053."[10]

Meanwhile, a compromise agreement between IRS and restaurant industry representatives was negotiated. The agreement afforded some protection to the industry

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[10] *See* I.R.C. § 45(b)(1)(A), as amended by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1112(a), 110 Stat. 1755, 1759; *see* H.R. Conf. Rep. No. 104-737 at 186-187, reprinted in 1996 U.S.C.C.A.N. 1677, 1678-79; S. Rep. No. 104-281 at 7-8, reprinted in 1996 U.S.C.C.A.N. 1474, 1480-83; H.R. Rep. No. 104-586 at 5-6 (1996). At the time of this amendment, the IRS was not assessing the tax in the manner it has done here so there would have been no need for Congress to do any more than it did. *See* J.A. 103-107.

while it continued to litigate the legality of IRS's interpretation of Section 3121(q) and to pursue relief from IRS's interpretation of Section 45B. Under the compromise Tip Reporting Alternative Commitment ("TRAC") program announced in June 1995, a restaurant agrees to educate its employees about tip reporting, establish procedures to ensure accurate tip reporting, and comply with all federal tax requirements. In exchange, IRS agrees to base the restaurant's FICA tax liability solely on additional tips reported by employees on their income tax returns (Form 4137) and on any unreported tips discovered during an IRS audit of an employee. While TRAC may be a far more palatable program, the threat remains of a debilitating assessment potentially exceeding twice a restaurant's average annual profits. *See supra*, at 9 n.6.

When some IRS offices used the threat of such an assessment to coerce participation in the voluntary agreement, restaurateurs once again sought congressional intervention and IRS advised the field that it was against IRS policy to threaten employer only audits. J.A. 103-107. This policy was subsequently codified. (IRS employees "may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering a [TRAC] Agreement.").[11] Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 685, 755 (July 22, 1998).

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[11] IRS argues Congress gave tacit approval to the employer only aggregate assessments by virtue of this amendment. Congress did not give approval to what IRS had assured Congress it had discontinued in practice.

With the protection afforded by the TRAC program and the availability of an offsetting dollar for dollar credit, one may ponder Fior's motivation for continued litigation. There are several reasons. First, the threat of an assessment of an employer share of FICA taxes on unreported tips for the 14 years since the amendment of Section 3121(q) is real. One court has already held that IRS has an open-ended statute of limitations. *LIR Management Corp. v. United States*, 86 F.Supp. 2d 340 (S.D.N.Y. 2000). It will take most industry employers many years to absorb an assessment of that magnitude, even with Section 45B's credit.[12] In addition, a tax credit is of little value to those employers in a precarious financial situation or with loss carry-forwards. A restaurant that barely breaks even does not owe enough in taxes for a tax credit to be of much assistance.

Most importantly, the greatest concern always has been, and continues to be, the industry's employees. The simplest way for the small restaurant employer, entitled to a dollar-for-dollar credit, to protect itself from an IRS threat of a financially devastating tax assessment is to find a way to force its employees to report at the level IRS seeks. Satisfying IRS's stated goals of average industry tip reporting at 14½%, when industry statistics indicate the actual figure is substantially less, will inevitably mean that many employees will be required to report more in tips than they actually earn, making their effective tax

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[12] Annual taxes at an estimated 30% of annual profits of 4% equals 1.2% of sales. It would take more than 6 years before the 45B credit would fully offset a potential FICA tax assessment on tips equal to 7.5% of annual sales. *See supra*, at 9 n.6.

rate one of the highest in the country. This, the restaurant employer wants no part of.

This case. Since the inception of this case, IRS has implied that Fior knew that its employees were not reporting the full amount of their tips and that Fior had an option to pay its employer share of FICA on an amount greater than the amounts reported to it by its employees. *See* for example, Gov. Brief before the 9th Cir. Filed 8/26/99 pp. 13, 33. Neither is correct.

Fior's employees receive tips on a *daily* basis either table-by-table as the patron departs or at the end of the employees' shifts when they "cash out." Tips are shared with indirectly tipped employees, for example, hostesses, busboys and bartenders, with the balance "pocketed." J.A. 60. *See* AGA brief. Fior's employees report their pocketed tips to the employer at the end of every *biweekly* payroll period throughout the year, in accordance with the requirements of Section 6053(a).[13] These amounts are processed for payroll purposes along with the employees' hourly wages, and the required FICA and withholding amounts are withheld and deposited by Fior.

Fior subsequently provides a reconciliation or accounting of such payments and collections to IRS on a *quarterly* basis using Form 941. Reg. 31.6011(a)-1, Reg. 31.6302-1. J.A. 80-88.[14] In accordance with the instructions

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[13] Reg. 31.3121(q)-1(c) provides that only tips retained by an employee are to be reported by him. The monthly liability reconciliations on Forms 941, J.A. 80-88, correspond with the bi-weekly payroll periods.

[14] Contrary to the Government's assertion (G.B. 20), the filing of Form 941 does not "impose" any taxes. The Form 941 is

on Form 941 and the mandate that the employer's Form 941 "return shall include wages received by an employee in the form of tips *only* to the extent of the tips reported by the employee to the employer in a written statement furnished to the employer pursuant to section 6053(a)," Reg. 31.6011(a)-1(a) (emphasis added),[15] Fior included on its Form 941 for both the employer's and employee's share of FICA only those tips reported to Fior by the individual employee. As is evident from the instructions to Form 941 and the Form itself there is no practical or legally authorized way for Fior to have included an additional amount of estimated tips (*i.e.*, the total credit card tips) for purposes of the employer share of FICA alone.

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merely an accounting of tax deposits already made. The inclusion of amounts on Form 941 is not coterminous with or even evidence of a liability for a tax imposed. Income and employee FICA taxes withheld, along with the employer's FICA deposits, are included in the lump sum total figures on the form (*see* lines 5, 6a, 6b, 7 and 11). Obviously, no tax is "imposed" on the employer for those amounts. The employer responsibility is only to collect these amounts. Similarly, the total figure may be adjusted by a variety of things, such as adjustments from other quarters and employee earned income credits. Form 941 therefore tells one nothing about the taxes imposed. It is the actual *payment* of the wages to the *individual* employee, not the subsequent commingling of it with other wage payments and accounting for it on Form 941, which triggers a tax liability and upon which the tax is *imposed*.

[15] *See also* IRS Field Service Advice Memorandum 1998-74 (holding that an employer is *prohibited* from filing an amended return or an adjustment on Form 941 even for amounts of unreported tips which the employer may have a reasonable basis for concluding the employee received (*i.e.*, as in the case of allocated tips or tips on credit card receipts), until such time as the Service sends a Notice and Demand).

No sales information is included on the Form 941 and no comparison to sales is made on the Form.[16]

In January of the subsequent year, Fior transposes the amounts of individual wage earnings, social security earnings, and tips reported onto individual employee W-2 statements and W-3 transmittals to the Social Security Administration ("SSA"). The employer is required to reconcile the amounts on the W-2's, W-3's, and the quarterly Form 941 filings throughout the year. Section 12 of IRS Publication 15 (2000) Circular E.

Two months after the close of the year, Fior compares its annual sales data with the total biweekly payroll data and completes and files Form 8027, providing IRS with the total amount of gross receipts, charged receipts, charged tips, and total tips reported. It was this form that revealed that Fior's employees had collectively reported less than the total amount included in the tip box on the credit card receipts. The difference led to an IRS tip compliance check whereby IRS used Fior's credit card charge slips to determine a tip percentage for the charges and then applied that tip rate to Fior's gross receipts to estimate an aggregate amount of the tips received by all of Fior's employees collectively. IRS then sent Fior a Notice and Demand for the employer share of FICA tax

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[16] In addition, payroll is often handled throughout the industry by outside payroll services who are not privy to sales data. Even when handled internally, payroll processing systems are separate and distinct from other accounting and financial systems and functions. *See* AGA brief.

on the difference between this aggregate amount and the amount of tips reported by all of its employees.

In doing so, IRS did not determine how much, if any, of the aggregate unreported tip income was tip income received by an individual employee amounting to less than $20.00 a month.[17] *See* 26 U.S.C. 3121(a)(12). Nor did IRS determine how much of the aggregate unreported tip amount was received by individual employees which, when added to such individual employee's other wages paid by the employer, exceeded the wage base and was therefore not taxable. *See* 26 U.S.C. 3121(a)(1). Nor did it determine how much of the aggregate unreported tip amount was received by individual employees in excess of the federal minimum wage, for which the employer is entitled to a Section 45B tax credit. *See* 26 U.S.C. 45B. Moreover, the aggregate amount of all employees' tips collectively tells nothing about the amount of tips retained by individual employees after tipping out, a practice which typically reduces a directly tipped employee's amount of tips retained by up to 25%. *See* J.A. at 60-62. *See also* AGA brief.

IRS also made no attempt to ascertain whether the gross receipts upon which it based its calculation included "carry-out" sales or "employee meals," which are often included in a restaurant's gross receipts but

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[17] IRS considers this issue "marginal." G.B. 36 n.26. IRS fails to recognize that the restaurant business is a very transient business with employee turnover rates as high as 200 to 400%. For some job categories, such as busboys and dishwashers, the turnover rate could be even higher with job slots repeatedly filled with those literally "here today, gone tomorrow."

upon which tips are seldom received. Nor did IRS attempt to determine the restaurant's policy with respect to "stiffs" or "walk-outs," which are often included in gross receipts for financial purposes then expensed, but upon which tipping is unlikely as IRS's own statistical evaluations have found. *Tip Income Study*, 4. Nor did IRS attempt to determine whether there existed any special methods of operation, such as a buffet, which would result in a different tip rate for certain sales.

IRS does not even know whether the amount designated as a tip on a charge receipt was in fact a tip. For example, IRS does not know to what extent customers use the tip line to procure cash to purchase cigarettes or to pay for valet parking or, as in some establishments, to feed video games – information which can obviously only be procured from the employee himself. IRS does not know whether charged tips were turned over to employees net of the credit card fees often charged by many employers, or whether the aggregate tips reported on Form 8027 included credit card amounts which were uncollectible for which the employer sought reimbursement from the employee.

Significantly, the documents supporting the Notice and Demand to Fior did not follow the Internal Revenue Manual directions, as is required for all tip compliance examiners in making determinations of additional taxes due. *See* Employment Tax Handbook of the Internal Revenue Manual "I.R.M.," section 4.23.7.13 (providing uniform employment tax audits instructions to IRS personnel). Specifically, the documents were not accompanied by direction to Fior that "Forms W-2 or W-2c must be issued to the employees." *See id.*, section 4.23.9.9.3. The

number of employees whose W-2's should be amended was not noted on the form as required. *Id.* Nor was the required reconciliation between FICA wages on Form W-3 or W-3c and FICA wages on Form 4468 performed by the auditor. *See id.*, section 4.23.9.10. The standard language on Form 4468 required by IRS procedures to be used in every employment tax audit was curiously omitted from the form used for this assessment.[18] Accordingly, no wage earnings history records for social security benefit computation purposes were, or ever can be, credited for the tip earnings the employees allegedly received.

In short no individual employees were identified, no individual tip earnings were determined, no W-2's were asked to be amended, and the SSA received no notification of an adjustment to individual employees' wage earnings history records despite the clear direction in the Internal Revenue Manual that these procedures are required in every employment tax audit. Instead, the tax was based solely upon the aggregate tip earnings of all employees collectively.

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[18] This language provides that "Under IRC sections 6051 and 6071 and the regulations under those sections, you are required to furnish Form W-2c (Statement of Corrected Income Tax Amounts) . . . to each of the ___ employees whose wages are adjusted by this report. Also you are required to file the original of these statements with Form W-3c [for transmittal to the SSA]."

SUMMARY OF THE ARGUMENT

This case is part of a long-running struggle between the IRS and the restaurant industry over the uncertainty inherent in accurately determining employee tip income. For more than 30 years, the IRS has attempted repeatedly to implement provisions that work in various ways to shift to employers the burden of accurately determining the tips received by their employees. Every time it has done so, however, the Congress has intervened and clarified that it is the job of IRS, and not of the employers, to police the accurate reporting of income by employees.

This case is simply IRS's latest re-invention of its efforts. This time, IRS asserts an authority to impose a tax upon employers based upon an aggregate estimate of total tip income received by all employees without ever inquiring into the individual instances of particular employees, or making any effort to determine the accuracy of their individual tip reports. IRS claims an inherent authority to advance such a gross approximation of total tips, and shift to the employer the burden of proving both its inaccuracy, and the total correct amount. If successful in this endeavor, IRS will have accomplished what Congress has denied it for decades – the right to make employers either take responsibility for tracking the tips received by its employees, or suffer the penalty of an inflated assessment advanced by the Government for their failure to do so.

Such a result must be rejected because the language, context and history of FICA tax provisions require the tax to be based upon determinations of individual employee tip earnings. It is simply impossible to administer the

FICA tax provisions of the code otherwise. The FICA tax is imposed on employees and employers, by Sections 3101 and 3111, based on the wages earned by individual employees. Both sections refer to the exact same definitional sections for determining what constitutes "wages" subject to the tax. When Section 3121(q) was amended in 1987 to subject all tips received to the employer share of FICA tax, the additional employer taxes were expressly conditioned upon a finding that the individual employee failed to report his tips. Congress also tied the employer's liability to a specific enforcement procedure – the issuance of a notice and demand – which as a result of, by regulation and longstanding agency custom and practice, entailed the determination and adjustment of individual wages earnings and the crediting of social security earnings histories for such earnings.

Further, assessing employer FICA tax on the basis of an aggregate assessment of the tip income of all employees would effectively nullify a number of statutory provisions. Without determination of the tip earnings of individual employees, employers would be unable to take advantage of both Section 3121(a)'s adjustments which may reduce the amount of tips which are actually considered "wages" subject to FICA taxation and Section 45B's credit for FICA taxes paid by an employer for tips in excess of the minimum wage.

Perhaps most importantly, the claimed authority to impose employer FICA taxes by means of aggregate assessments would frustrate the very purpose of FICA tax – to provide individuals with protection under the social security system. Congress made wages earned the basis for determining the benefits ultimately to be

received. If IRS were authorized to assess an employer's FICA tax without making a determination of the income received by that employer's individual employees, it would be impossible to credit those employees to get wage earnings credit for such tips. Moreover, assessing employer FICA taxes on tip income while failing to credit employees for tip earnings distorts FICA into a general welfare tax and provides a windfall for the Government.

Notwithstanding this individual focus, IRS purports to have authority under Section 6201 to assess employer FICA taxes based on an aggregate estimate of the tip income earned by all employees collectively. But Section 6201 does not give IRS the power it claims. Unable to cite any authority for that proposition, the Government instead argues by analogy to Section 446(b), which has been construed as authorizing IRS, in the income tax context, to impose tax assessments based on estimates where individual taxpayers have not kept their own appropriate records from which income can be determined. The argument is unpersuasive because Fior, unlike the taxpayer subjected to assessment under Section 446, has kept all appropriate records and is in no way at fault for reporting the amounts reported to it by the employee. Indeed, under the law, it had no choice but to do so. Moreover, if Section 6201 conferred a general power to levy assessments by estimate, even absent taxpayer fault or failing, then Section 446(b) would be wholly redundant and unnecessary.

The legislative history of the FICA provisions further demonstrate that Congress intended employer FICA tax to be based upon determinations of individual employee tip earnings, and not an aggregate estimate which is

demonstrably inaccurate in many ways, but which the employer must live with unless he can come forward with a more accurate number. For the past thirty-plus years, IRS has repeatedly attempted, in varied and creative ways, to shift the burden of determining tip income to employers of tipped employees. In response, Congress has repeatedly rejected IRS's attempts to place this onus on employers, affirming that the admittedly difficult job of determining unreported tip income rests not with the employer, but with IRS.

Not only is IRS's claimed aggregate assessment authority without basis in the statute and contrary to the legislative history, it has no basis in sound tax enforcement policy either. IRS has ample avenues open to it to address the problem of under-reporting of tips by employees. Indeed, it appears that by utilizing those tools, IRS has already made an appreciable impact on the tip under-reporting problem. To the extent the problem remains significant, the aggregate assessment method is hardly a solution. It leaves unpaid about 75% of the taxes associated with tip under-reporting – both the employee's share of FICA and the employee's income taxes. Indeed, in view of the tax credit provision of Section 45B, profitable restaurant employers will receive a one-for-one credit for the FICA taxes paid for tips in excess of the minimum wage, leaving only unprofitable restaurants significantly impacted financially by the aggregate assessment method that the Government says is so important.

Even if the language, context, and legislative history of the FICA tax provisions did not clearly demonstrate Congress's intention that an employer's FICA tax be

based upon a determination of the tip earnings of individual employees, no deference would be owed to IRS's current construction of the FICA provisions. IRS's construction is nothing more than its current litigating position, for which it has no long-standing reasoned explanation or promulgation in support. In fact, IRS documents discussing the proper method for assessing an employer's FICA tax unanimously agree that this tax should be based upon determinations of individual employee tip earnings.

ARGUMENT

IRS DOES NOT HAVE AUTHORITY TO BASE EMPLOYER FICA TAXES ON AN AGGREGATE ESTIMATE OF THE TIP INCOME OF ALL EMPLOYEES COLLECTIVELY

Congress imposed an employer FICA tax on the tip earnings of *each* individual employee, not the gross tip earnings of all employees *collectively*. The employer FICA tax is a tax on the exact same thing as the employee tax: the "wage" earnings of each individual employee. In both instances the "wages" subject to the tax must be established by a determination of individual employee earnings. It is not possible to administer the FICA tax provisions of the Code consistent with the statutory language, framework, and purpose otherwise.

A tax imposed on the remuneration of all employees collectively as opposed to a tax on the total wages paid to each individual employee is not a distinction without a

difference.[19] A tax on the aggregate earnings of all employees collectively is not just a matter of the wrong amount or the wrong means of reaching the amount due – it is a tax on the wrong "thing" altogether. Since the employer is not liable for a FICA tax on an aggregate estimate of the tips received by all employees collectively, but a tax on the tip "wages" of individual employees, Fior did not dispute the facts or determinations used to tax the aggregate unreported tip income for purposes of summary judgment, but instead challenged the *entire* assessment. Pet. App. 39a; J.A. 25-26.[20]

A. Congress Intended The Employer FICA Tax To Be Based Upon A Determination Of The Tip Earnings Of Individual Employees

The fact that Congress intended that the employer FICA tax be based on the wage earnings of *each*

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[19] In this regard, IRS is wrong when it suggests an estimate based upon the average tip rate and gross sales of the restaurant is far more likely to achieve factual accuracy than individual audits. For instance, if an employer has two employees, one who made $75,000 and the other $25,000 a tax based on an estimate of gross wage earnings would be imposed on $100,000. On an individual basis, with a FICA wage base of $55,500, the employer share of FICA would be based on $80,500 ($55,500 + 25,000).

[20] In addition, Fior challenged the assessment on constitutional grounds: (1) the constitutional provisions relating to uniformity and equality of taxation have been violated by IRS's singling out employers of tipped employees for the denial of earnings credits; and (2) the application of an estimation method against one who has complied fully with the law raises due process concerns. J.A. 26.

individual employee rather than on the aggregate wage earnings of all employees *collectively* is manifest in the statutory provisions, the statutory scheme, and the legislative history behind them. *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 126 (1934). ("The true meaning of a single section of a statute in settings as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part.").

1. The Statutory Language Imposing The FICA Tax Requires That It Be Determined Based Upon The Taxable Tips Of Individual Employees.

In ascertaining the intent of Congress the court starts, as it must, with the language of the section. The language of the operative FICA sections is consistently focused on the individual. Both Sections 3101 and 3111 impose a tax *"equal to the following percentages of wages (as defined in section 3121(a))* . . . with respect to employment (as defined in section 3121(b)) . . . " (Emphasis added.) Section 3121(a) provides that " . . . the term 'wages' means all remuneration for employment . . . except" 21 enumerated exceptions which must be determined based on each individual employee's specific compensation package. Section 3121(q) provides: "tips received by *an* employee shall be considered remuneration for such employment."

While the tax on the employee is an income tax, the tax on the employer is an excise tax on the employment relationship. *Helvering v. Davis*, 301 U.S. 619, 645 (1937).

The employer's share of the FICA tax is triggered not merely by entering into an employment relationship, however, but by the *payment of wages* in the context of that relationship. Reg. 31.3111-3. An employer does not pay wages to all employees collectively, but pays wages to *each* employee *individually*. The employer's liability for FICA taxes therefore attaches to *each* of these individual payments, not when they are later summed and reported, as the government argues. GB. 19-20.[21] Since it is the *payment* of wages to the *individual* employee which triggers the tax, the FICA statute defines "wages" subject to the employer and employee taxes identically.

Sections 3101 and 3111 both impose a tax on the exact same thing: *"wages as defined in section 3121."* In this case that means "tips received by an employee," Section 3121(q), whether reported to the employer or not, and as adjusted by Section 3121(a), are subject to both the employer and employee FICA tax. In the context of the employee FICA tax, this provision clearly refers to the *individual* employee's tips, since the employee cannot be taxed under Section 3101 on anything but his own tips. Since Sections 3101 and 3111 both refer to the same definitional section, the employer FICA tax provision must also refer to the tips received by that individual employee. *See Sullivan v. Stroop*, 496 U.S. 478, 484 (1990)

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[21] The government suggests that the fact that an employer does not account for and is not "assessed" FICA tax separately for each employee is indicative of the fact that the tax is not *imposed* upon individual employee earnings. This conclusion is not warranted. An "assessment" does not create the liability but merely acts as a judgement for taxes found due. *Bull v. United States*, 295 U.S. 247, 259 (1935).

("Identical words used in different parts of the same act are intended to have the same meaning."); *Rowan Companies v. United States*, 452 U.S. 247 (1981) ("It would be extraordinary for a Congress to intend, without ever saying so, for identical definitions to be interpreted differently.").

Moreover, a construction of Section 3111 as imposed upon "employees' aggregate tip income" cannot be consistently applied. When an employee reports his tips the section would be construed as applying to the tips of an individual employee; when he fails to report, IRS would construe the tax as applying to all tips of all employees collectively. Section 3111 cannot be read as imposing a tax on tips of all employees collectively some of the time, and a tax on individual employees at other times. The tax is imposed on the tips received by each individual employee all the time.

Such a conclusion is reinforced by consideration of the 1987 amendments to Section 3121(q) subjecting all tips received to the employer's portion of the tax. The amendments conditioned the employer's liability for FICA taxes on unreported tips on inaccurate or incomplete employee tip statements. Such statements are not prepared by all employees collectively but by each employee individually.

Congress's also conditioned the tax upon the issuance of a "notice and demand" as opposed to some other event. This requirement is an unequivocal indication of Congressional intent that the tax be imposed upon a determination of individual tip earnings with credit to the SSA records of individual employees for such tip

earnings. A "notice and demand" is a term of art with a clear procedural path to be followed before its issuance. For every employment tax audit of an employer, the Internal Revenue Manual directs the auditor to require the employer to prepare and issue corrected W-2c's showing the exact amount of any additional "wages" determined on each individual employee's W-2c. The employer is further directed to transmit each of these corrected W-2c's to the SSA for wage history benefit purposes. The auditor is directed to prepare Form 4668 Employment Tax and Examination Changes Report and to "insert the number of employees whose Forms W-2 should be amended by filing Forms W-2c on Form 4668." The auditor is instructed to reconcile the FICA wages on the corrected W-2c's with the adjustments on his report. If the corrected forms cannot be obtained from the employer, the auditor is directed to "attach a list of employees who should receive wage statements to Form 4668." *See* I.R.M. 4.23.2.13 and 4.23.9.9-10. Regulation 31.6051-1(c)(1)(ii) requires these procedures and the correction of employees' W-2s. For unagreed cases the reports (Forms 4668 along with others) will be sent to the employer with a preliminary (30-day letter). I.R.M. 4.23.9.11.2. If the matter remains unagreed a "notice and demand" will issue.

These are the procedures to be followed in all audits. When Congress amended Section 3121(q) to provide that an employer would be liable for the tax when "notice and demand" is issued, Congress intended the employer

share of FICA taxes on unreported tips be determined by application of these procedures.[22]

2. This Conclusion Is Confirmed By Other Provisions Of FICA.

Even if the above statutory provisions did not have "a dispositively plain meaning," *United States v. Cleveland Indians Baseball Co.*, 532 U.S. 200 (2001), Congressional intent is not manifest in the words of the statute alone. The fact that an assessment based on an aggregate estimate of the tip earnings of all employees collectively conflicts with other FICA provisions and renders them meaningless is further evidence that Congress intended FICA taxes to be based upon determinations of individual wage earnings.

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[22] The fact that the statute imposes the employer's share of FICA taxes on an employee's tips when the employee fails to report them and that such taxes can be assessed separate from, at a later date than, and regardless of whether the employee is audited, assessed, or even pays the tax, does not support a construction of the statute as imposing the tax on tips received by all employees collectively as IRS argues. G.B. 4, 8, 15, 16, 17, 19, 20.

The timing of the employer's obligation to pay the tax under Section 3121(q) (*i.e.*, when a notice and demand issues) does not re-characterize it as one imposed on tip earnings of all employees collectively. To the contrary, a proper reading of the statute is that when Fior is provided a "notice and demand" for FICA taxes on additional tip earnings of an individual employee (either as reported by the employee on Form 4137 with his income tax return or as adjusted after an IRS audit of the individual tipped employee), Fior owes the tax, and the fact that the employee has not been audited, assessed, or paid his share does not relieve Fior of its liability to pay.

Section 3121(a) provides that 21 exceptions may apply to determine what amount of an individual employee's "remuneration" is actually "wages" subject to FICA taxation. *See* Section 3121(a)(1)-(21). Those adjustments include, for example, exclusion from "wages" for amounts received by an employee in excess of the contribution and benefit base and below $20.00 per month in tips. These adjustments, along with the 20 others, must be computed on an individual, employee-by-employee basis and cannot be computed in the aggregate. They would therefore be eliminated under a determination of wages in the aggregate. *See* Treas. Reg. §§ 31.3121(a)(1)-1(a)(2) and 31.3121(q)-1(d). Section 3121(a)'s adjustments cannot possibly be given effect in any context but the determinations of individual earnings – a clear indication of Congressional intent that the tax be determined on an individual basis.

Nor can Section 45B be given effect without determination of the tip earnings of individual employees. Section 45B provides a credit for FICA taxes paid on tips of an employee in excess of the minimum wage. Obviously, a determination of amounts in excess of the minimum wage must be on an individual basis.[23] "An

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[23] IRS misunderstands the district court's holding with respect to the 45B credit. The 1996 amendments to the 45B credit were enacted for the specific purpose of providing a credit for tips which employees fail to report to the employer. However, the operative language of 45B provides a credit for FICA taxes paid on tips "received by an employee". If a notice and demand is issued in the aggregate, the FICA taxes are not paid "with respect to tips received by an employee," once again defeating the very purpose of the statute.

employer cannot take advantage of this tax credit if the IRS assesses his FICA taxes on unreported employee tips in the aggregate." Pet. App. 47a. As the district court below stated:

> Sections 3121(a) and 45B therefore indicate that Congress intended that individual wage assessments would be made before the employer's share of FICA taxes could be assessed. . . . [Otherwise], those credits and exemptions would become a nullity for many employers. It is a basic rule of statutory construction "that one provision should not be interpreted in a way . . . that renders other provisions of the same statute inconsistent or meaningless."

Id. 48a (citations omitted).

3. Allowing IRS Authority To Proceed By An Aggregate Estimate Of Employees' Tips Will Frustrate FICA's Core Purpose Of Securing Employee Benefits.

An aggregate assessment based upon the tip earnings of all employees collectively is also inconsistent with the FICA statute's core purpose of providing retirement income security because an aggregate assessment denies individual employees wage earnings history credits for such tips. If wage determinations for individual employees are not made a part of the process of adjusting the amount of FICA tax owed by an employer, notification cannot be sent to the SSA of the additional tip earnings for purposes of crediting the wage earnings histories of individual employees for future social security benefit purposes.

Congress's purpose in subjecting tips to FICA in the first place was to provide "better protection under the social security program for more than a million [tipped] employees and their dependents." H. R. Rep. No. 213, *supra*. This purpose did not change when Congress decided that "in order to apportion the cost of social security benefits more accurately, employers should be subject to tax on all tips *which are credited for benefit purposes.*" Senate Committee Report 100-63 at 203 (1987) 133 Cong. Rec. S34,826 (1987) (emphasis supplied). While it is not intended that benefits should be measured exactly by the amount of payments, the underlying scheme is based upon the general relationship of the benefits to the wages earned and the taxes paid thereon. *Mathews v. de Castro*, 429 U.S. 181, 186 (1976); *Flemming v. Nestor*, 363 U.S. 603, 608 (1960).

The amount of the monthly benefit to which an individual is entitled is directly related to the "average monthly wage" as reflected in the "wages records" which the Treasury Secretary is required to maintain. 42 U.S.C. 405(c). If the wage records of the individual fail to reflect the receipt of covered earnings or wages, no ensuing benefits will be accorded. When individual earnings are not determined and individual wages earnings histories not credited, the assessment, as the lower court found "amounts to a tax on the employers without a commensurate benefit to the employees . . . and operates as a general revenue tax for the government beyond the purpose of FICA taxes." Pet. App. 46a. But the basis of an employer FICA tax on wages is to pay the cost of the social security benefits reasonably anticipated for the individual employee of that employer. The purposes of

the employer and employee FICA taxes are identical – to provide one-half each of the cost of social security benefits to which an identified individual employee may become entitled. *See* Testimony of J. Roger Mentz, Assistant Treasury Secretary for Tax Policy, before the House Ways and Means Committee on the President's fiscal year 1988 revenue initiatives (The amendment to 3121(q) "follows the general structure of Chapter 21 [concerning FICA] that requires an equal tax to be paid by both parties. . . . ") News Release, Doc. 87-598, Feb. 4, 1987.

If Congress had intended a different purpose for employer social security taxes, for example, to finance welfare programs or social security benefits generally, there would be no need for the 21 exceptions from employer payroll taxes available under Section 3121(a). That Congress intended that employer FICA taxes on unreported tips to be based upon a determination of tip earnings of individual employees with credit to the SSA records of those individual employees for such tip earnings is the only interpretation consistent with the statutory purpose of providing social security protection.[24]

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[24] IRS argues that employees have waived their entitlement to wage earnings credits. This argument ignores the fact that not only employees but society as a whole has an interest in its working citizens receiving social security protection. Further, it appears that employees may be denied wage earnings credit even if they do ultimately report to IRS the correct amount of tips received. According to SSA correspondence from 1993, such credits will be recorded only where the employer files the corrected amount on a Form W-2c, J.A. 70, and in this instance that can only occur where the employer receives information from IRS indicating the corrected tip figure for the individual employee. *See* discussion *supra* pp. 19, 30.

Congressional intent has been clearly and unambiguously expressed through the words of the statute, the statutory scheme, and the articulated purpose of enacting the Social Security Act and subjecting tip income to social security coverage. Since "Congress has directly spoken to the precise . . . issue," to wit, that the employer FICA tax is to be based upon a determination of the tip earnings of each individual employee, "that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 842 (1984).

B. Sections 6201 And 446 Do Not Provide Authority For IRS To Determine Employer FICA Taxes Based On An Aggregate Assessment Of Employee Tip Income

Notwithstanding the individualized nature of the employment tax provisions of the code, IRS argues that Section 3111 nonetheless imposes a liability for employer FICA tax on all tips received and asserts its broad based authority under Section 6201 to collect it by means of an aggregate assessment. Since the language of Section 6201 cannot itself reasonably be read to confer such authority, IRS argues by analogy to Section 446(b) that assessing an employer's FICA taxes based on an aggregate estimate of the tip earnings of all employees collectively is permissible. Section 446 is not analogous however, and Section 6201 cannot confer authority to IRS which is specifically negated elsewhere.

Section 446(b) has been interpreted to allow IRS to estimate an individual employee's income for income tax purposes if that employee has not kept proper records of tip income and there is therefore no way to determine precisely the amount due. Because tipped employees themselves are responsible for any inadequacy in their tip income records, courts have held that the IRS's use of estimates under this section is justified. *See Mendelson v. Comm'r*, 305 F.2d 519 (7th Cir. 1962) ("Obviously, where a taxpayer keeps no records disclosing his income, no method can be devised which will produce an exact result."); *McQuatters v. Comm'r*, 32 T.C.M. (CCH) 1122, 1125 (1973) ("In the absence of adequate record keeping by petitioners, [the IRS] was justified in reconstructing their tip income by an indirect method. . . . "). Although Section 446 applies to income taxes and does not give the IRS power to estimate FICA taxes, it illustrates the balance Congress has chosen to strike – an estimated method of assessing income may be used in the income tax context if the taxpayer himself has failed to maintain adequate records, caused them to be destroyed, or is somehow at fault in a way that prevents the IRS from making an accurate determination of income.

Even then, the faulty taxpayer is never denied the chance to adjust IRS's result. Thus, for instance, in *McQuatters*, the court held that a flat rate approach was appropriate *only* after concluding on the basis of testimony from the individual waitresses that there were not significant variations in the services performed which would result in differences in individual amounts of tip income. In addition, the court reduced the flat rate percentage by nearly 20% from that proposed by IRS to

account for many factors raised by individual employees.[25] Here, without personal knowledge of the tips received, Fior, which did everything required of it under the law, is effectively denied the defenses, available to even the most culpable of taxpayers, which the court in *McQuatters* found persuasive enough to warrant a significant reduction in IRS's determination of liability.

The necessary premise and implication of the Government's attempt to analogize to the authority granted under Section 446 is that Fior has somehow acted improperly. But that is not true. Fior is not permitted to make a FICA tax payment based on an estimate drawn from credit card tips. Fior has no option to pay on an amount greater than the amount reported to it by the individual employees pursuant to Section 6053(a). Reg. 31.6011(a)-1(a) prohibits this and requires that the employer's "return shall include wages received by an employee in the form of tips *only* to the extent of the tips reported by the employee to the employer." The instructions to Form 941 preclude it and the form itself makes no provision for such an option. Accordingly, the only records the law requires Fior to keep are the employee tip reports pursuant to Section 6053(a). Reg. 31.6001-5(a)(16).

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[25] This result flies in the face of IRS's repeated assertion throughout its brief, G.B. 9, 25, to the effect that a flat rate approach or aggregate estimate is more likely to achieve accuracy than individual determinations of tip earnings. It also illustrates that while the sum of individual audits may be nothing more than the sum of individual estimates that approach could result in a materially and significantly lower figure than that proposed by IRS on an aggregate basis.

In the absence of any wrongdoing, the analogy to Section 446 fails. Section 6201 provides no general authority to determine FICA taxes based on aggregate assessments. The inappropriateness of such a procedure is highlighted by the fact that Fior is not the taxpayer who was required to maintain the records necessary to overcome IRS's estimate.

Rather than look for what does not exist in Section 6201 IRS would be well advised to consult its terms again. Section 6201 provides: "The Secretary is authorized and *required* to make the inquiries, determinations, and assessments of all taxes. . . . " What it authorizes and requires here is an inquiry into the tip income received by individual employees.

C. The Legislative History Of The FICA Statutory Provisions Demonstrates That Congress Did Not Authorize The IRS To Assess Employer FICA Tax Based On An Aggregate Estimate Of The Tip Income Of All Employees Collectively

The Government claims a power to proceed against employers for their share of FICA taxes on tips by means of a crude, top-down estimate of total employee tips, which the employer must either live with, or refute and replace with a more accurate number based on better information. But, precisely because the determination of tip income for tax purposes has long been a difficult subject for the IRS, it has many times been the focus of congressional attention and action, going back to at least 1964. Among the products of those actions, of course, are the provisions discussed in the preceding sections which

are best and most harmoniously read as requiring that the tax be administered on the basis of determinations of individual wage earnings.

Of equally great note, however, is the legislative history of congressional actions clarifying beyond doubt that employers may not be made to bear the burden of the uncertainty inherent in accurately determining employee tip income. From the beginning, Congress took the view that the "only practical way" to get accurate tip information was to "require employees to report their tips to the employer." H.R. Rep. No. 213, *supra*. In 1976, when the IRS adopted revenue rulings that would have expressly obligated the employers to determine and report all tip income, whether or not it was reported accurately by the employees, Congress enacted legislation that expressly overrode those actions. P.L. 94-455, *supra*.

In 1982, in response to IRS lobbying for greater information concerning tip income, Congress enacted Section 6053(c) for the express purpose of assisting the IRS in "its examination of returns filed by tipped employees," but flatly declined to make employers responsible for determining or verifying the accuracy of employee reports of tip income. In 1987, Congress adopted the present language of Section 3121(q), which, on the one hand, made clear that the Section 3111 tax extends to all tips received, but, on the other hand, made clear that where tips are not accurately reported, the tax is only owing upon submission of "notice and demand" by IRS, which process by both regulation and long standing enforcement practice, requires the determination and SSA crediting of wage earnings on an individual employee basis.

Congress's emphatic denial of any IRS power to shift the burden of uncertainty to the employer continued in the 1990s. In response to an outright effort to coerce employer cooperation in forcing employees to report tips at an average aggregate percentage of sales, Congress enacted a tax credit, Section 45B, which refunded, on a dollar-for-dollar basis, all employer FICA taxes paid in excess of minimum wages. When the IRS sought to negate the section's effect by conditioning it upon actual reporting of the tips by employees – and thus again incentivize the employer to police the employee reporting of tips, Congress again adopted (in 1996) legislation expressly rejecting the IRS action and making clear that the credit was available whether or not the tips had been accurately reported.

In sum, the present effort to proceed by aggregate assessment, and thus shift the burden of establishing the correct amount of employee tip income to the employer, is just the latest in a series of efforts by the IRS. The present statutory provisions, which show no sign of conferring the power that is now claimed, are just part of the story. Equally significant are the many congressional actions taken to frustrate creative IRS efforts to avoid the burden of examining the income of individual employees and shift that responsibility to the employer. For that reason, as well, this Court should affirm the decision below.

D. The Government's Argument Based On Urgent Necessity Is Unpersuasive

With no legislative grant of authority to shift the burden for determining the accuracy of employee tip reports to employers, and a strong legislative history to the contrary, the thrust of IRS's argument boils down to an assertion of convenience tantamount to urgent necessity – the IRS must be given this power because the determination of tip income is a knotty problem that cannot be adequately addressed in any other way.

The Government thus comes before the Court hat-in-hand, begging the Court's forbearance lest it be unable to do its job of collecting the nation's revenues. It has not sought to help itself by enacting any scheme of regulations or other coherent plan of action to which this Court could apply the usual tools of judicial review. *See* Section E, *infra*. Instead, it seeks to be confirmed in its right to act in an *ad hoc* manner, contrary to law and history, based on the absence of practical alternatives. Such an argument would be unpersuasive even if the aggregate assessment method were in fact a real answer to an otherwise insoluble problem. In fact, the approach of assessing aggregate unreported tips is a non-solution, and the Government has substantial powers to address the actual problem at hand.

In particular, Congress has granted IRS broad powers to determine the amount of individual tips received. Through the enactment of Section 6053(c), Congress ensured IRS access to information adequate to trigger its own inquiries in cases where there is a likelihood of significant tip underreporting by employees. While it is

not the case that employers generally have superior information concerning the actual amounts of tips received by employees – and thus the core premise for shifting the burden to employers is fallacious – to the extent employers may have some information unknown to the IRS, *see* G.B. 38, n.28, any such information is readily available to the IRS through its audit and subpoena powers.

Nor is the Government limited to doing individual audits, one at a time, in order to increase the amount of individual employee tips for which employers are liable in FICA taxes. As *McQuatters, supra*, and the long line of tax court cases disclose, the flat rate approach of assessing all the servers in an establishment for their individual income taxes on additional tip income, is a frequent and successful tool used by IRS. In addition, IRS can certainly collect a substantial amount of its alleged shortfall by simply sending employers a bill for their share of FICA taxes on the additional tips their employees report directly to the IRS on Form 4137. Additional amounts could also readily be collected by pursuing by letter, the list of employees provided IRS annually to whom an allocation was made under Section 6053(c). As the documents at J.A. 68-71 and 90-93 indicate, this is precisely what Congress intended, and what IRS was actually doing before it decided it was much easier to simply "slap . . . the employer with assessments based on aggregate estimates," Pet. App. 15a. To the extent the Government perceives a need to proceed further, desk audits can be undertaken by sending the identified employees computer generated assessments for amounts in excess of the allocation.

All of these options are available to IRS at minimal time and expense. All will have the beneficial result, required by the statute, of identifying individual under-reporting employees and causing their wage earnings records to be corrected for social security benefit purposes.

Further, the figures cited by the Government, Pet. 19-20, belie its argument based on urgent necessity. IRS notes that only half of all tips were being reported 15 years ago. Pet. 19. Tip reporting has increased by 170% according to the figures presented by IRS "without any corresponding increase in industry revenues" and during the precise time that IRS had a strict policy against employer-only assessments. J.A. 103-107. Assuming the earliest figures quoted by the IRS represent reporting at the 50% level, the most recent period figures correlate with reporting at 84% of all tips received.[26] This is consistent with the fact that $11.4 billion in tips for 1997, Pet. 20, equals 9.9% of 1997 full-service restaurant sales of $112 billion. 1997 Economic Census, U.S. Bureau of Census, Summary, Accommodations and Foodservice Subject Series, Table 1. Such a level of tip reporting – 9.9% of restaurant sales – amounts to 83.3% of total tips received, if one accepts the conclusion of Treasury's *Tip*

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[26] IRS states that in 1994 total Foodservice Industry tips reported were $8.52 billion. Pet. 20. If this amount represents 50% of all tips received as IRS suggests by reference to the *Tip Income Study Id.*, total tips received would be twice that or $17.04 billion. The 1999 total tips reported for the industry of $14.31 billion, Pet. 20, is 84% of this total tips received of $17.04 billion, which IRS indicates has remained constant since 1994.

Income Study, p. 3 that tips are paid at an average rate of 11.9%.

The Government's urgent necessity argument makes no sense for another reason as well. To the extent that employee's are underreporting their tips by any significant amount, it is not only the 7.65% employer FICA tax that is going unpaid. The employee FICA tax at the same rate, and the employee income tax at a likely average rate of 15%, are also left uncollected. Thus, by failing to pursue the employee directly, and instead imposing an aggregate estimate on just the employer's share, the IRS is leaving uncollected roughly 75% of the unpaid taxes relating to underreporting of tip income. Worse, even the 25% that is being recovered is an illusion, to the extent the employer has income taxes due against which to take a credit under Section 45B. Thus, it is only the employers who are not making any profit, and therefore are unable to take that credit, who are materially impacted by the aggregate assessment of FICA taxes.

In sum, beyond the fact that the statute and legislative history clearly deny any power in the IRS to assess employer's FICA taxes based on an aggregate estimate of tips, there is no reason to accept the Government's argument that such an approach is necessary – or even desirable – in order to remedy the problem of chronic underreporting of employee tip income.

E. No Presumption Of Correctness Or Other Deference Is Due To The Government's Asserted Authority To Proceed By Aggregate Assessment

The Government leads off its argument with the assertion of a "presumption of correctness," under which the taxpayer in a refund case can only challenge an assessment by proving that the amount is erroneous, and further offering its own evidence to establish the correct amount of the tax. G.B. 10-14. This contention, of course, begs the entire question at issue in this case – whether the Government has authority under the FICA statutes to proceed by an aggregate assessment of tip income without ever focusing on the income received by individual employees. If, as Fior contends, it does not have that power, then the assessment itself is simply an unauthorized act by the IRS. It is "naked and without any foundation," *see United States v. Janis*, 428 U.S. 433, 442 (1976), and, as such, provides no basis on which to shift the burden of factual proof to the taxpayer. *Id.* at 441; *Helvering v. Taylor*, 293 U.S. 507, 514-515 (1935).

Beyond this effort to pretermit the Government's own Question Presented – addressing agency authority to impose an aggregate assessment – with a burden-shifting catch-22 argument, the Government wisely offers no further claim that deference is owed to administrative action. Plainly there is no basis here for any such claim.

When a court, employing traditional tools of statutory construction, determines that the intent of Congress has been unambiguously expressed, "that is the end of the matter; for the court, as well as the agency, must give

effect to the unambiguously expressed intent of Congress." *Chevron*, 467 U.S. at 842 n.9. This is especially true here, since the IRS has not articulated a contradictory construction, except in litigation. No regulation, revenue ruling, revenue procedure, technical advice memorandum, or any other document, issued by IRS either explains the agency's current interpretation or suggests that the aggregate assessment policy is the considered enforcement policy of IRS. What does exist is either silent or explicitly states that the aggregate assessment method is *contrary* to IRS policy.[27]

Two internal documents, from 1996 and 1998, advise the IRS field officers that "any assessment made against the employer must mirror those first made against the individual employees." J.A. 106, J.A. 103-107.[28] More

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[27] The only IRS authority ever issued addressing how the employer's share of additional FICA taxes on unreported tips is to be imposed is silent as to the procedure. Rev. Rul. 95-7 1995-1 C.B. 185 poses the question: "How is a notice and demand made for purposes of section 3121(q) of the code?" and answers: "no specific form or procedure is prescribed."

[28] In the Table of Contents of the Joint Appendix, Government Counsel has elected to list these letters under the heading "Non-Record Document." That characterization is incorrect. These memoranda are issued to "Regional Chief Compliance Officer," by officials of the IRS in Washington. They were incorporated into the record, by attachment to Fior's brief in the Ninth Circuit, at the first opportunity after they were made public pursuant to a FOIA request. They were the subject of discussion in the argument before the court below, and also of post-argument correspondence with the court. There can be no doubt that they are properly part of the record before the court below, and thus part of the record before this Court. *See* S. Ct. Rule 26.1.

specifically, the second of these memoranda, issued June 24, 1998, states that:

> Assessments made against both the employer and the tipped employee should be based on amounts from either Form 4137, *Social Security and Medicare Tax on Unreported Tip income* (filed by the employee with the employee's Form 1040) or amounts reflected on Form 885-T, *Adjustment of Social Security Tax on Tip Income Not Reported to Employer*, prepared at the conclusion of an employee tip examination.

J.A. 106. The same memorandum also notes:

> We have also received congressional inquires that employer-only assessments are still being performed by IRS examiners, although our current policy prevents this. Please ensure that all affected IRS personnel working on the Tip Initiative follow the current procedures related to tip examinations.

J.A. 107.

Clearly, the current contentions of the Government are nothing more than a litigating position, arrived at without rulemaking or any above-board policy formulation of any sort. "Deference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate." *Bowen v. Georgetown University Hospital*, 488 U.S. 204, 213 (1988).

Under such circumstances, as this court held last term in *United States v. Mead*, 533 U.S. 218, 121 S.Ct. 2164 (2001), no deference is owed to IRS with respect to this matter. *See also Bowen*, 488 U.S. at 213 ("we have declined to give deference to an agency counsel's interpretation of

a statute where the agency itself has articulated no position on the question"); *Investment Company Institute v. Camp*, 401 U.S. 617, 628 (1971) ("the courts may not accept appellate counsel's post hoc rationalization for agency action").

CONCLUSION

For the foregoing reasons, the judgment of the Court below should be affirmed.

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No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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REPLY BRIEF FOR THE UNITED STATES

1. a. The question presented in this case is whether the employer's share of FICA tax on employee tip income must be determined by accumulating the result of individual audits of individual employees or may instead be based on a reasonable estimate of the aggregate amount of tips received by all employees. As we note in our opening brief, 26 U.S.C. 6201 broadly authorizes the Secretary to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title." Under that statute, courts have long upheld the agency's general authority to use reasonable estimating procedures in making tax assessments for "all taxes" imposed by the Internal Revenue Code, in-

cluding income, excise, and FICA taxes. See U.S. Br. 21-22 (citing cases); *id.* at 24-25 (citing cases).

It is telling that respondent does not dispute this basic proposition and does not contest the holdings of these cases. Instead, respondent contends only that the general authority to make assessments based on reasonable estimates of items of income is unavailable *for employer FICA tax calculations* because that authority is "specifically negated elsewhere" in the Code. Resp. Br. 36. In making that assertion, however, respondent fails to cite any statute that "specifically negates" the authority of the Service to make reasonable estimates of items of income in making employer FICA tax assessments—and no such statute exists.[1]

Respondent ultimately acknowledges that the tax provisions involved in this case impose "the employer's share of FICA taxes on an employee's tips [even] when the employee fails to report them and that such taxes can be assessed [on the employer] separate from, at a later date than, and regardless of whether the em-

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[1] Amicus American Gaming Association (AGA) claims that Section 6201 does not authorize the Service "to use any particular method of assessment, much less the method employed by the IRS here." Am. AGA Br. 12. In making this assertion, however, AGA ignores the established principle that the use of reasonable estimates in determining items of unreported income is a valid method of determining a disputed factual issue. U.S. Br. 21 (citing cases); see *id.* at 22-25. As the court emphasized in *Palmer* v. *IRS*, 116 F.3d 1309, 1312 (9th Cir. 1997), the fact that Congress has specified no particular methods or evidentiary burdens on the Commissioner in making an assessment reflects that the Commissioner "has wide discretion" in accomplishing that administrative task. See also *United States* v. *Janis*, 428 U.S. 433, 437, 441 (1976) (describing the calculation of a wagering excise tax assessment based on a reasonable estimate of wagers made); U.S. Br. 22 (citing additional cases).

ployee is audited, assessed, or even pays the tax * * * ." Resp. Br. 31 n.22.[2] The provisions involved in this case thus impose this tax directly, and independently, on the employer. They do not "specifically negate" or in any fashion depart from the general principle that assessments may be based on reasonable estimates of the items of income to which the tax applies. Accordingly, every court of appeals that has considered this issue, other than the court below, has correctly upheld the use of reasonable aggregate estimates of tip income in making assessments of the employer share of the FICA tax. See, *e.g.*, *Bubble Room, Inc.* v. *United States*, 159 F.3d 553, 566 (Fed. Cir. 1998); U.S. Br. 24 (citing cases).

b. Respondent errs in contending that estimates of items of income are permitted only when there has been "wrongdoing" by the taxpayer or when the taxpayer "is somehow at fault in a way that prevents the IRS from making an accurate determination of income." Resp. Br. 37, 39. Respondent points to no language in Section 6201 or any other provision of the Code that establishes such a condition on the use of reasonable estimates in making assessments. Respondent also fails to cite any case that holds that such a condition exists.

The condition that courts have actually imposed on the use of estimates in making tax assessments is that the assessment must not be "naked and without *any* foundation." *United States* v. *Janis*, 428 U.S. 433, 442 (1976). See also *Carson* v. *United States*, 560 F.2d 693,

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[2] Amicus AGA similarly acknowledges that, under these tax provisions, "an employer may be liable for its portion of FICA taxes even where an employee fails to report all tips." Am. AGA Br. 11.

696 (5th Cir. 1977) (the Service must provide "some factual foundation for its assessments"); *Gerardo* v. *Commissioner*, 552 F.2d 549, 554 (3d Cir. 1977) (assessment requires a "minimal" evidentiary foundation and the Service must "provide some predicate evidence connecting the taxpayer to the charged activity"); *DiMauro* v. *United States*, 706 F.2d 882, 885 (8th Cir. 1983) (same); *Weimerskirch* v. *Commissioner*, 596 F.2d 358, 361-362 (9th Cir. 1979) (same).

The assessment involved in this case is not "naked and without *any* foundation." Instead, for the reasons articulated previously (U.S. Br. 17-18), it reflects a reasonable estimate of tip income based on the information submitted by respondent to the IRS on Form 4070.[3] Even though respondent now purports to identify ways in which this estimate of tip income could be improved (Resp. Br. 18-19), it is far too late for such objections to be raised. In the courts below, respondent expressly and unequivocally elected *not* to dispute either the factual foundation or the reasonableness of the Service's aggregate estimate of tip income. J.A. 35; See U.S. Br. 18. Moreover, respondent offered no competing evidence to challenge the assessment. *Ibid.* Since the assessment had a rational basis, and since respondent offered no evidence to rebut the amount of taxes assessed, judgment should have been entered in the government's favor on both the refund and collection claims in this case. *Ibid.* See also *id.* at 10-14.[4]

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[3] There is no genuine dispute that a substantial underreporting of tips in fact occurred. See Pet. App. 2a n.2; U.S. Br. 18 n.16.

[4] Respondent does not now dispute that, even if the assessment *had* lacked a rational basis, the only consequence of an invalid assessment would be to shift the burden of persuasion to the

2. In arguing that the employer FICA tax may be determined only by adding up individual employee tips, respondent emphasizes (Resp. Br. 27-29) that 26 U.S.C. 3121(q) refers in the singular to tips received by "an employee in the course of his employment." Respondent fails to note, however, that Section 3121(q) does not impose the employer FICA tax. Instead, Sections 3111(a) and (b) furnish the statutory basis for the tax. 26 U.S.C. 3111(a), (b). These Sections do not impose the employer share of the tax separately on the wages earned by each discrete employee. They instead impose a single tax on the aggregate, qualified "wages" paid by the employer "with respect to having *individuals* in his employ." *Ibid.* (emphasis added).

The employer FICA tax imposed under Sections 3111(a) and (b) is computed as a percentage of "the wages (as defined in section 3121(a)) paid by [the employer] with respect to employment (as defined in section 3121(b))." 26 U.S.C. 3111(a), (b). Section 3121(a) defines the term "wages" collectively as "all remuneration for employment." 26 U.S.C. 3121(a). That formulation reflects that only a single assessment of the employer share of the FICA tax, made collectively for all wages that the employer pays, is required.

Respondent errs in relying on the fact that certain exclusions to the FICA taxes set forth in Section 3121(a) describe the excluded payments as being made

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government on the amount of taxes due in the collection case. See U.S. Br. 10-14. The documents in the record of this case reflect an undisputed underpayment of tax, for the credit card tips alone that are noted on respondent's reports exceed the tips on which respondent paid FICA tax. See Pet. App. 2a n.2; U.S. Br. 18 n.16. This evidence, by itself, would have supported a judgment that respondent owed more taxes than it reported and paid to the government. See U.S. Br. 14.

to an "employee" in the singular. Resp. Br. 27-28. The statute employs both the singular and the plural to describe various types of covered wage payments, referring to services from "employees" (26 U.S.C. 3121(b)(12)(B)), "service performed" for an employer (26 U.S.C. 3121(b)(7), (11), (15)), "service performed by foreign agricultural workers" (26 U.S.C. 3121(b)(1)), as well as to services provided by "an employee" (26 U.S.C. 3121(b)(9)) or "an individual" (26 U.S.C. 3121(b)(9), (13)). The emphasis that respondent would give to isolated singular, rather than plural, references in the statutory text is therefore inappropriate. Moreover, as several courts have pointed out (see, *e.g.*, *Bubble Room, Inc.* v. *United States*, 159 F.3d at 563-564; *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d 990, 995 (7th Cir. 2000)), any reliance on the singular or plural character of these isolated provisions violates the basic principle of statutory construction that:

> [i]n determining the meaning of any Act of Congress, unless the context indicates otherwise—*words importing the singular include and apply to several persons*, parties, or things; *words importing the plural include the singular* * * * .

1 U.S.C. 1 (emphasis added).

3. a. Respondent is incorrect in its contention that an aggregate assessment "conflicts with other FICA provisions and renders them meaningless." Resp. Br. 31. In particular, respondent errs in claiming that "wages" must be determined on a per-employee basis in order to give account to the "wages band" of Section 3121(a). As we explain in our opening brief, a reasonable estimate of tip income (and thus a valid assessment) may be adjusted or challenged by evidence

from the taxpayer that particular employees fell outside the wages band. U.S. Br. 17-18, 35 n.25. In this case, however, respondent affirmatively elected *not* to advance such a challenge and instead stipulated that, "[f]or purposes of this litigation alone, [t]axpayer does not dispute the facts, estimates and/or determinations used by IRS as a basis for its calculation of an amount of aggregate unreported tip income by all directly and indirectly tipped employees of the taxpayers collectively." J.A. 35. That stipulation was made when the case was in the district court and is, of course, binding on respondent at this stage of the case as well.

As a consequence of respondent's stipulation, there is no evidence in the record of this case to show that any of the evidentiary flaws of which respondent now complains are present. Moreover, the factual objections are directly inconsistent with respondent's evidentiary stipulation in the district court.[5] See U.S. Br. 34-39. As Judge McKeown emphasized in her dissent in the court of appeals, "the issue of accuracy is not before us, because [respondent] did not challenge the accuracy of the calculation * * * ." Pet. App. 33a.[6] Moreover,

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[5] In its brief in this Court (Resp. Br. 18-19), respondent makes several new factual arguments that have no support in the record. For example, respondent claims that the "IRS does not know to what extent customers use the tip line to procure cash[,] to purchase cigarettes or to pay for valet parking or * * * to feed video games." Resp. Br. 19. That sort of factual interjection is barred both by respondent's failure to provide any evidentiary support for its claim and by respondent's stipulation that it does not "dispute the facts, estimates and/or determinations used by IRS" in making the assessment involved in this case. J.A. 35.

[6] Respondent incorrectly suggests (Resp. Br. 18) that tip-sharing (or "tipping out") reduces the amount of tips meeting the definition of "wages" to be included in the employer's FICA tax base. The employer's liability under Section 3111 is based on total

even if a challenge to the accuracy of the assessment *had* been made in the district court—and had succeeded —it would not have provided a basis for "invalidating" the assessment. It would only have provided a basis for redetermining the amount of taxes that respondent must pay. *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996-997; *Bubble Room, Inc.* v. *United States*, 159 F.3d at 567; see U.S. Br. 10-14, 34-35.[7]

b. Respondent also renews the assertion adopted by the district court that "[a]n employer cannot take advantage of th[e] tax credit [afforded by Section 45B of the Code] if the IRS assesses his FICA taxes on unreported employee tips in the aggregate." Pet. App. 47a. In rejecting this same contention in *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 997, the court of appeals correctly observed that the taxpayer's claim "is once again misplaced."

The Section 45B credit is available for employer FICA taxes on all employee tips *except* those that are applied (under 29 U.S.C. 203(m)) to satisfy the employer's minimum wage obligation. 26 U.S.C.

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remuneration, including tips, deemed to have been paid by him to *all* employees. The total remuneration of the employer's workers remains the same whether a directly-tipped employee retains all of his tips or passes a portion of them along to another employee.

[7] An "assessment is intended to be an estimate. It is expected to be rational, not flawless." *Dodge* v. *Commissioner*, 981 F.2d 350, 353 (8th Cir. 1992), cert. denied, 510 U.S. 812 (1993). Even if there were proof that the amount of the assessment were incorrect, that would not invalidate the assessment. "When a court is faced with an incorrect but otherwise valid assessment, the proper course is not to void the assessment * * * but to determine what, if anything, the taxpayer owes the government." *United States* v. *Schroeder*, 900 F.2d 1144, 1148 (7th Cir. 1990). See U.S. Br. 34-35.

45B(b)(1)(B).[8] The employer knows the amount of tips that are eligible for the Section 45B credit, for it knows whether (i) its direct wage payments to its employees meet the minimum wage obligation (in which case all tips are eligible for the credit) or (ii) its wage payments are less than the minimum wage (in which case the portion of tips in excess of those needed to satisfy the minimum wage are eligible for the credit). The suggestion that an aggregate determination of employee tips for purposes of assessing the employer portion of the FICA tax would somehow nullify the credit allowed by Section 45B is thus simply incorrect. *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 997; U.S. Br. 26-27 & n.19.

4. a. Respondent complains that employers are being put in the role of "monitoring" or "policing" employees' compliance with their tip reporting and FICA

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[8] The employer portion of the FICA tax for tips received by employees in "connection with the providing, delivering, or serving of food or beverages" (26 U.S.C. 45B(b)(2)) may be credited against the employer's income tax liability for the period in which the tax is paid. 26 U.S.C. 45B(a). The amount of this credit, however, is limited to the amount of the FICA taxes paid with respect to the portion of the tips received for such services *after* the federal minimum wage obligation for the employee has been satisfied. 26 U.S.C. 45B(b)(1)(B). The employer whose employees receive such tips may pay less than the minimum wage directly to a tipped employee, and may treat tips received by the employee as satisfying a portion of the statutory minimum wage. 29 U.S.C. 203(m); see U.S. Br. 26. The limited income tax credit afforded by Section 45B for the employer FICA tax on food and beverage service tipping thus does not, as respondent suggests (Resp. Br. 14), eliminate the tax consequences of the issue presented in this case. Moreover, the tax credit afforded by Section 45B does not apply to all other tipping situations, such as taxicabs, hair salons, or the host of other commercial activities to which FICA applies.

tax obligations. Resp. Br. 9, 21. In fact, however, respondent is being asked only to perform the same task that every other taxpayer must perform: to pay the taxes imposed on it under the Internal Revenue Code.

The possibility that respondent's employees may be evading taxes on part of their tips cannot excuse respondent's liability for the employer portion of this tax. Indeed, respondent has acknowledged that Section 3111 imposes "the employer's share of FICA taxes on an employee's tips [even] when the employee fails to report them." Resp. Br. 31 n.22. Respondent further acknowledges that the employer portion of the FICA taxes may be assessed on the employer "separate from, at a later date than, and regardless of whether the employee is audited, assessed, or even pays the tax" (*ibid.*). See also note 2, *supra*.

b. Respondent asserts that an employer has insufficient information to challenge a determination of employer FICA tax liability on unreported tip income when aggregate assessments are used. Resp. Br. 9, 38. That claim, however, is belied by the proceedings in the *Bubble Room* and *Morrison Restaurants* cases. As explained previously, issues of fact were properly raised to challenge the amount of an assessment in those cases and those issues were properly addressed and resolved in a timely fashion in proceedings before the agency and in district court. U.S. Br. 38. In the present case, however, respondent expressly elected not to raise such factual contentions in the courts below and is therefore precluded from raising them in this Court in the first instance. See *Id.* at 13 n.8.

5. Respondent errs in contending that aggregate assessments of the employer portion of the FICA taxes would frustrate the "core purpose of securing employee

benefits" (Resp. Br. 33). Respondent claims (Resp. Br. 8 n.3, 34) that this "core purpose" is revealed by a single sentence in the Senate Finance Committee staff explanation of Section 3121(q), which states that FICA taxes are collected from employers "on all tips which are credited for benefit purposes." Staff of Senate Comm. on Finance, 100th Cong., 1st Sess., S. Prt. 100-63, *Explanation of Provisions Approved by the Committee on December 3, 1987, for Inclusion in Leadership Deficit Reduction Amendment* (Comm. Print 1987).

The ambiguous statement in the Senate Finance Committee staff report on which respondent relies cannot, and does not, alter the requirements of the statute. As the *Bubble Room* Court stated: "[t]he statement that 'employers should be subject to tax on all tips which are credited for benefit purposes' must be read in context and with the understanding that the Senate staff was likely contemplating an ideal world in which employees report all of their tips." 159 F.3d at 564.

If resort to this staff report were thought appropriate, there is an unambiguous statement in the same report that is more germane to the question at hand: "Thus, employers must pay FICA taxes on the total amount of cash tips and other remuneration, up to the Social Security wage base." S. Prt. 100-63, *supra*, at 203. Accord, H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 802 (1987); H.R. Rep. No. 391, 100th Cong., 1st Sess. Pt. 2, at 855 (1987). Indeed, as respondent has conceded (Resp. Br. 31 n.22), it is unquestionably the "total amount" of tips received by the employees, and not simply the amount of the tips that they report, that defines the employer's liability.

Moreover, social security benefits earned by an employee are not based on the taxes paid by the employer or the employee but on the covered wages

that are earned and reported. 42 U.S.C. 405(c)(2)(A). Employees receive Social Security earnings credit for tips that are reported either (i) in statements they submit to their employer pursuant to 26 U.S.C. 6053(a) or (ii) in statements they submit to the IRS on Form 4137. See *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996; *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530; SSA, Social Security Handbook § 1408 (when employee reports additional tip income on Form 4137, "IRS reports the additional income to [Social Security Administration for] credit[ing] to [the employee's] earnings record."). An employee fails to receive Social Security credit for tips earned only if he fails to report those earnings, as required by law. See *330 West Hubbard Restaurant Corp.* v. *United States*, 203 F.3d at 996; *Bubble Room, Inc.* v. *United States*, 159 F.3d at 565; *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530.

Respondent similarly errs in asserting that there is a necessary linkage between the employer FICA tax on wages and the "social security benefits reasonably anticipated for the individual employee[s] of that employer." Resp. Br. 34. It has long been understood that no such linkage exists and that an imbalance in one direction or the other between taxes paid and benefits received is inevitable. See *Flemming* v. *Nestor*, 363 U.S. 603, 609-610 (1960). Respondent's argument reflects a misunderstanding of the relationship between FICA taxes and benefit payments. Social Security taxes collected from respondent are used to pay benefits to today's retirees; they are not linked in any fashion to the payment of benefits to respondent's current employees when they retire in the future. *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d at 1530. See also *Flemming* v. *Nestor*, 363 U.S. at 609;

Bubble Room, Inc. v. *United States*, 159 F.3d at 564-565.

6. Respondent argues that the legislative history of various provisions that address the tax treatment of tips provides support for the contention that Congress has not authorized assessments based on a reasonable estimate of the aggregate amount of tips received by all of a restaurant's employees. Resp. Br. 1-14, 39-41. The history cited by respondent, however, does not support that contention.

When Congress responded in 1998 to restaurant industry complaints about the IRS practice of assessing an employer's liability for FICA taxes based on aggregate tip income—and about the decision of the Eleventh Circuit in *Morrison Restaurants* approving that practice—Congress elected not to prohibit the IRS from following that practice. Instead, Congress chose to direct IRS employees not to "threaten to audit any taxpayer in an attempt to coerce the taxpayer" to enter into a tip reporting agreement. See U.S. Br. 29 (quoting Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3414, 112 Stat. 755). By approving the concept of tip reporting agreements—under which the IRS agrees not to make an aggregate assessment in exchange for tip reporting actions taken by the employer—Congress necessarily acknowledged that aggregate assessments are generally permissible in the absence of such an agreement. See U.S. Br. 30.[9]

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[9] As Judge McKeown pointed out below, in enacting this statute Congress necessarily "*acknowledged the IRS's power to make aggregate calculations* of employer tax obligations" (Pet. App. 28a), for it would make no sense for a restaurant to enter into a tip reporting agreement in return for the Service's agreement not to do that which under respondent's theory it lacks authority

7. Respondent errs in urging (Resp. Br. 29-31) that the form of the notice and demand for payment of taxes that was issued by the Service in connection with the assessments involved in this case is at odds with various portions of the Internal Revenue Manual (IRM). This is an entirely new claim that was not raised or addressed either in the district court or in the court of appeals. It is therefore not properly presented in this case. *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970).

This new argument is unavailing in any event. Respondent claims that the Internal Revenue Manual directs the agency's auditors to require employers to prepare corrected wage statements for individual employees when the income attributed to them is adjusted, and to then transmit those corrected statements to the Social Security Administration. Resp. Br. 19, 30, citing IRM 4.23.7.13 and 4.23.9.9-10. Respondent asserts, without any supporting authority or analysis, that, in the absence of such corrected statements, a notice and demand for taxes (and a subsequent assessment of those taxes) may not be issued. Resp. Br. 30-31. That argument is defective in several respects.

(i) In the first place, the procedures for correcting W-2 wage statement forms are not part of the notice and demand procedures for the assessment of FICA taxes on unreported tip income. The provisions of the Internal Revenue Manual that deal with notice and

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to do. Indeed, "[i]t would be stranger still if Congress thought abusive or illegal the IRS's practices of making assessments against employers before or without making assessments against employees and did not correct that abuse in its major reform of the IRS in 1998 * * * ." *330 West Hubbard Restaurant Corp.* v. *United States*, 37 F. Supp. 2d 1050, 1054-1055 (N.D. Ill. 1998), aff'd, 203 F.3d 990 (7th Cir. 2000).

demand of FICA taxes under 26 U.S.C. 3121(q) are located at IRM 4.23.7.12.6 rather than IRM 4.23.7.13 (cited by respondent). See Rev. Rul. 95-7, 1995-1 C.B. 185, 186.

Under the provisions of the Manual that actually apply for this purpose, it is correct that a "notice and demand" is a prerequisite to an employer's liability for FICA taxes on unreported tips and that "the employer is not liable for its portion of the FICA taxes on those tips until notice and demand for the taxes is made to the employer by the Internal Revenue Service." Rev. Rul. 95-7, 1995-1 C.B. 185, 186 (Q&A 6).[10] This is because Section 3121(q) of the Code specifies that "such remuneration shall be deemed * * * to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary." 26 U.S.C. 3121(q).[11]

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[10] This pre-assessment notice and demand requirement of Section 3121(q) is additional to, and separate from, the notice and demand requirement of Section 6303(a). The latter statute requires the Service to provide a statement of the amount owed by any taxpayer, for any tax, "*after* the making of an assessment of a tax." 26 U.S.C. 6303(a) (emphasis added). Section 3121(q), by contrast, applies only before assessment and concerns only the employer's liability for FICA taxes on unreported tip income. See 26 U.S.C. 3121(q). Contrary to respondent's suggestion, the "procedural path" (Resp. Br. 30) for issuance of *pre*-assessment notice and demand under Section 3121(q) is obviously not identical to the "procedural path" for the issuance of *post*-assessment notice and demand under Section 6303(a).

[11] Taxes generally are due at the time the return reporting such taxes is due. 26 U.S.C. 6151(a); 26 C.F.R. 31.6151-1(a). An employer's quarterly FICA tax returns are ordinarily due on the last day of the first calendar month following the end of the quarter. 26 C.F.R. 31.6071(a)-1(a)(1); see 26 C.F.R. 31.6011(a)-1(a)(1); 26 U.S.C. 6011(a), 6071(a). Thus, an employer's liability for FICA taxes is due with the quarterly return for the quarter in which the notice and demand is made. Rev. Rul. 95-7, 1995-1 C.B. at 186 (Q&A 9).

Contrary to respondent's contention (Resp. Br. 29), however, the notice and demand required for this employer FICA assessment to proceed is simply a notice and demand for the *aggregate amount of taxes owed by the employer*, not an assessment somehow broken down by each individual employee. The Service in fact sent a pre-assessment "notice and demand for the taxes" owed by respondent (Rev. Rul. 95-7, 1995-1 C.B. at 186 (Q&A 6)), and a copy of that notice and demand is lodged in the record. J.A. 41-42. No further or different "notice and demand for taxes" is required by the agency's manual before the assessment could be made.

(ii) Even if the pre-assessment notice and demand issued to respondent had *not* complied with the Internal Revenue Manual, that would be of no consequence in this litigation. The provisions of the Internal Revenue Manual establish operating procedures for IRS employees. These procedures, however, are not binding on the IRS and confer no rights on taxpayers. *E.g.*, *First Alabama Bank, N.A.* v. *United States*, 981 F.2d 1226, 1230 n.5 (11th Cir. 1993); *Urban* v. *Commissioner*, 964 F.2d 888, 890 (9th Cir. 1992); *United States* v. *Horne*, 714 F.2d 206, 207 (1st Cir. 1983); *Einhorn* v. *DeWitt*, 618 F.2d 347, 350 (5th Cir. 1980). See also *Schweiker* v. *Hansen*, 450 U.S. 785, 789-790 (1981); *United States* v. *Caceres*, 440 U.S. 741, 752-753, 755-756 (1979). A failure of an agency employee to follow the operational guidelines set forth in the Manual does not provide a basis for a taxpayer to avoid payment of the taxes that Congress imposed in the Internal Revenue Code.

8. In litigation conducted over the last decade, the United States has consistently advocated that the Service may assess the employer portion of the FICA taxes based on reasonable aggregate estimates of unre-

ported employee tip income. Respondent nonetheless makes the implausible assertion that such aggregate assessments of the employer portion of the FICA taxes are contrary to IRS policy. Resp. Br. 25, 47. In support of this assertion, respondent cites two internal IRS memoranda written in 1996 and 1998. These memoranda describe the agency's self-imposed moratorium on aggregate assessments during the period that the issue now before this Court was being litigated in the lower courts.[12] The 1996 memorandum was issued in response to the adverse decision of the Court of Federal Claims in *Bubble Room, Inc.* v. *United States*, 36 Fed. Cl. 659 (1996). That decision was subsequently vacated by a decision of the Federal Circuit that upheld the government's position on this issue. 159 F.3d 553 (Cir. 1998). During the pendency of that appeal, the 1996 memorandum stated that aggregate assessments

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[12] These memoranda were not introduced into the record of the district court. The government was thereby deprived of any opportunity to provide explanatory affidavits or other relevant materials. See J.A. 102. Notwithstanding respondent's unsupported assertion to the contrary (Resp. Br. 47 n.28), the extra-record materials belatedly offered by respondent are entitled to no consideration at this stage of the case. Evidentiary materials that were not "filed in the district court" are not part of the "record" in the district court (Fed. R. App. P. 10(a)) and are therefore not to be included in the appendix or considered on appeal. See, *e.g.*, *United States* v. *Harris*, 542 F.2d 1283, 1308 (7th Cir. 1976), cert. denied, 430 U.S. 934 (1977); *United States* v. *Dunham Concrete Products, Inc.*, 475 F.2d 1241, 1251 (5th Cir.), cert. denied, 414 U.S. 832 (1973); *Tanner* v. *United States*, 401 F.2d 281, 288 (8th Cir. 1968), cert. denied, 393 U.S. 1109 (1969); *Jackson* v. *United States*, 131 F.2d 606, 607 (8th Cir. 1942) ("We cannot, of course, concern ourselves with anything which does not appear in the record."). See also Sup. Ct. R. 26.1-26.2 (authorizing the inclusion of "parts of the record" and "portions of the record" in the Joint Appendix).

would not be issued "[u]ntil all issues relative to this court case [were] resolved." J.A. 104. The 1998 memorandum offered similar guidance on employer FICA tax assessments in view of the fact that legislation was pending at that time to modify tip reporting agreement procedures. J.A. 106-107; see U.S. Br. 29-30.

Neither of these memoranda suggests that the IRS thought it lacked authority to make aggregate assessments. Indeed, the agency's continued litigation of that issue demonstrates the contrary. These memoranda instead reflect an orderly and temporary moratorium on such assessments while the question of the agency's authority was under consideration in the courts and before Congress. And, this self-imposed moratorium was lifted by the agency following the entry of the appellate decisions upholding the agency's assessment authority in the *Bubble Room*, *330 West Hubbard* and *Morrison Restaurants* cases. See IRS News Release IR-2000-26 (Apr. 26, 2000), *reprinted in* BNA *Daily Tax Report* at L-1 (Apr. 27, 2000).

* * * * *

For the foregoing reasons and the reasons set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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APRIL 2002

Supreme Court, U.S.
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No. 01-463

In the Supreme Court of the United States

UNITED STATES OF AMERICA, PETITIONER

v.

FIOR D'ITALIA, INC.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF OF PATRICIA R. GUANCIAL AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF THE *AMICUS CURIAE* [1]

Patricia R. Guancial is a private citizen. She was previously employed as a waitress and directly experienced the effects of the IRS's aggregate method of estimating unreported tip income, since her employer used this method to allocate tips to her which she did not earn. Her concern for the welfare of similarly situated employees has led to the filing of this brief. Ms. Guancial has not previously appeared before this court as *amicus curiae*.

SUMMARY OF ARGUMENT

The Court's decision in this case will affect both employers and employees in tip-receiving businesses. The use of aggregate estimates to assess the employer's FICA tax on unreported tip income creates a burden that ultimately and inappropriately may fall on the employees who will bear the costs of the tax. The decision of the Ninth Circuit should be affirmed. The IRS does not have the authority to use aggregate estimates in FICA assessments.

It is inappropriate for the IRS to refuse to credit the FICA accounts of employees under 42 U.S.C. § 405(c) for FICA taxes paid by an employer as the result of an

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[1] Pursuant to U.S. Supreme Court Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for a party, and no person or entity, other than *amicus* and her counsel, made a monetary contribution to the preparation or submission of this brief. The parties' written consents to the filing of this brief have been filed with the Clerk of the Court.

aggregate estimate of unreported tip income. The purpose of the Social Security system would be undermined by permitting the IRS to impose FICA taxes without crediting the accounts of tip-receiving employees. Aggregate estimates of unreported tip income may significantly overestimate the amount of tip income received and impose a burden not only upon the employer, but ultimately on the employees.

Judge McKeown, dissenting from the Ninth Circuit opinion, contended that the accuracy of aggregate estimates is an entirely separate issue from authority to make these estimates. *Fior D'Italia v. United States*, 242 F.3d 844, 858-59 (2001) (McKeown, J., dissenting), *cert. granted* 122 S. Ct. 865 (2002). The issue of accuracy is necessarily tied to the authority to make these estimates. If the estimates are inaccurate, no one will claim a portion of the FICA taxes paid by the employer, because the accurate earnings records of the employees will not reflect these amounts.

If FICA taxes are imposed without credit to any employee's account, the FICA tax will become a general revenue raising tool, rather than the system of employee benefits as it was designed.

The petitioner contends that allocation of the FICA taxes paid by the employer would be administratively impractical. This is in direct opposition to the fact that the IRS conducts employee level audits of unreported tip income and uses estimates in increasing tip income to employees. The IRS should either use this employee level estimate to apportion FICA credits, or abandon the

method in the employee income assessment context if it is truly imprecise.

ARGUMENT

I. AGGREGATE ESTIMATES OF EMPLOYER FICA LIABILITY DENY FICA CREDITS TO EMPLOYEES AND IMPERMISSIBLY TRANSFORM SOCIAL SECURITY INTO A GENERAL REVENUE RAISING DEVICE

The Social Security system in the U.S. is based upon the premise of a form of "social insurance" for the benefit of employees receiving wages qualified under the system. *See Fior D'Italia v. United States*, 21 F. Supp. 2d 1097, 1102 (N.D. Cal. 1998), *aff'd* 242 F.3d 844, *cert. granted* 122 S. Ct. 865 (2002). *See also Flemming v. Nestor*, 363 U.S. 603, 609 (1960). The FICA taxes that support Social Security are not intended to be a "general revenue gathering tool for the government". *See Quietwater Entertainment, Inc. v. United States*, 80 F. Supp. 2d 1323, 1329 (N.D. Fla. 1999); *Bubble Room, Inc. v. United States*, 36 Fed. Cl. 659, 674 (1996), *vacated and remanded by* 159 F.3d 553 (Fed. Cir. 1998). *Accord Mathews v. de Castro*, 429 U.S. 181, 185-86 (1976); *Reynolds v. Northern Pacific Railway Co.*, 168 F.2d 934, 939 (8th Cir. 1948), *modified sub nom. Reynolds v. Chicago, St. P., M. & O. Railway Co.*, 168 F.2d 944 (8th Cir. 1948), *cert. den. sub nom. Railway Employees' Department of the American Federation of Labor v. Northern Pacific Railway Co.*, 355 U.S. 828 (1948). Contributions to the Social Security system are intended to result in a future benefit to the employee, when the employee is unable to work. *Quietwater*, 80 F. Supp. 2d

at 1329, citing *Weinberger v. Wisenfeld*, 420 U.S. 636, 647 (1975). *Cf. Social Security Board v. Neirotko*, 327 U.S. 358, 362 (1946), *United States v. Fogarty*, 164 F.2d 26, 29 (8th Cir. 1947).

The petitioner claims that the payment of FICA taxes is dependent only upon the earnings records of the employee and not the payment by the employer. This is based upon a flawed interpretation of *Flemming v. Nestor*, 363 U.S. 603 (1960). *Flemming* addressed the issue of whether payments into the Social Security system represented an accrued property right. *Id.* at 608. The present case concerns taxes imposed without respect to an individual employee's earnings record, an issue not addressed by *Flemming*.

It is the administrative policy of the IRS to allow aggregate assessments of employee tip income for the purpose of determining the employer's FICA liability. *See 330 W. Hubbard Restaurant Corp. v. United States*, 203 F.3d 990, 992 (7th Cir. 2000); *Bubble Room, Inc. v. United States*, 159 F.3d 553 (Fed. Cir. 1998); *Morrison Restaurants Inc. v. United States*, 118 F.3d 1526, 1529 (11th Cir. 1997); *LIR Management Corp. v. United States*, 86 F. Supp. 2d 340, 341 (S.D. N.Y. 2000); *Quietwater*, 80 F. Supp. 2d at 1328; *Fior D'Italia*, 21 F. Supp. 2d at 1102. The purported authority for these assessments has been 26 U.S.C. §§ 446(b), 3121(q) or 6201. *See, e.g., Bubble Room*, 159 F.3d at 565-66. The aggregate method of assessing employer liability does not appear explicitly within these statutes and arises only from administrative procedures. *See e.g., LIR*

Management Corp., 86 F. Supp. 2d at 345; *Quietwater*, 80 F. Supp. 2d at 1328.

These administrative procedures have been inconsistently applied and have led to assessments that have been struck down as excessive in a number of contexts. For example, the differences between charge tips and cash tips, tip-outs, and the "wages band" have all resulted in aggregate estimates of unreported tip income which were reduced by the courts. *See Fior D'Italia*, 242 F.3d at 846-47; *Quietwater*, 80 F. Supp. 2d at 1330; *Bubble Room*, 36 Fed. Cl. at 663. *Accord Yukimura v. Commissioner*, 43 T.C.M. (CCH) 467, 470 (1982).

Judge McKeown contended that accuracy of the assessments and authority to make aggregate assessments should not be confused. *Fior D'Italia*, 242 F.3d at 858-59 (McKeown, J., dissenting). *See also Bubble Room*, 159 F.3d at 568. In fact, the two issues are inextricably linked. If the assessment is an accurate determination of the income of all employees, the aggregate reporting of the employees should match this amount. It is likely, and shown in practice to be the case, that an aggregate estimate at the employer level overestimates the amount of tip income received. *See Fior D'Italia*, 242 F.3d at 846-47; *Bubble Room*, 36 Fed. Cl. at 676.

If the aggregate estimate of the employees' tip income is inaccurate, the FICA taxes imposed will not correspond to the actual amounts of income received, or required to be reported by the employees. The employees will report and pay their share of FICA taxes only on the amounts actually received. The employees

will be entitled to benefits only on the amounts that they report. Since the practice of the IRS in reported cases has been to assess solely against the employer without an allocation among the employees of FICA credits, there is no matching of the FICA taxes paid with the credits that should correspond to payment. *See Fior D'Italia*, 242 F.3d at 846; *330 W. Hubbard Restaurant Corp.*, 203 F.3d at 996; *Bubble Room*, 159 F.3d at 571; *Morrison Restaurants Inc.*, 118 F.3d at 1528; *Quietwater*, 80 F. Supp. 2d at 1326; *LIR Management Corp.*, 86 F. Supp. 2d at 343.

If the employees report a lower amount of earnings than is assessed against the employer, the excess FICA taxes paid by the employer will be paid into the undesignated coffers of the government. Since the Social Security Act was not designed to be a "general revenue raising" device, this action is contrary to the intent of the statute. *See Quietwater*, 80 F. Supp. 2d at 1329; *Bubble Room*, 36 Fed. Cl. at 674. *Accord Mathews v. de Castro*, 429 U.S. at 185-86; *Reynolds v. Northern Pacific Railway Co.*, 168 F.2d at 939.

The costs of excess FICA taxes without credit to employee FICA accounts are costs which will inevitably be passed on to others. Employees without credit to their FICA accounts must make other arrangements for retirement and disability income. Also, the immediate expense of the taxes must be passed on through the

business.[2] These expenses may be passed on by purchasing lower-quality goods for resale, foregoing improvements to the premises, lowering employees' salaries, or reducing the number of employees.

The imposition of FICA taxes in such a way that may result in the loss of employees' jobs is clearly contrary to the purpose of the Social Security system. Permitting the IRS to use an aggregate method in this context will only allow the IRS to expand various audit methods in the future and force more taxpayers into the extraordinarily difficult position of disproving the adjustments proposed by the IRS. *See e.g., Fior D'Italia*, 242 F.3d at 848.

The IRS is not authorized to transform the purpose of the Social Security system into a general revenue gathering tool. In practice, this is what has occurred in the context of tip-receiving businesses. *See Fior D'Italia*, 21 F. Supp. 2d at 1102; *Quietwater*, 80 F. Supp. 2d at 1329-30; *Bubble Room*, 36 Fed. Cl. at 674. As the District Court stated: "a tax on employers based on aggregate assessment without individual employee credit, operates as a general revenue tax for the government beyond the purpose of the FICA taxes." *Fior D'Italia*, 21 F. Supp. 2d at 1102. The obligation of the IRS in administering FICA tax assessments is thus not for the generation of revenue, but rather must be consistent with the aims of a delayed benefits plan for the employees covered.

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[2] The total cost to employers of FICA taxes on estimated tip income may be greater than a normally imposed FICA tax, due to the disallowance of the 26 U.S.C. § 54B credit against income taxes. *See Fior D'Italia*, 21 F. Supp. 2d at 1102-03.

The IRS has contended and successfully argued that the failure of employees to report their tips amounts to a waiver of Social Security benefits. *See 330 W. Hubbard*, 203 F.3d at 996; *Bubble Room*, 159 F.3d at 565; *Morrison*, 118 F.3d at 1530; *LIR Management Corp.*, 86 F. Supp. 2d at 346-47. Not only does the Social Security Act not provide for the waiver of benefits, but the result is inappropriate. Since the aggregate estimate may overestimate employees tip income, the employees may not have records which would apportion the entire amount of FICA taxes imposed against the employer.[3]

Collection of FICA taxes without credit to an individual account is not supported by the legislative history of the Social Security Act. *See Morrison Restaurants Inc. v. United States*, 918 F. Supp. 1506, 1514 (N.D. Ala. 1996), *rev'd* 118 F.3d 1526 (11th Cir. 1997); *Quietwater*, 80 F. Supp. 2d at 1329-30; *Fior D'Italia*, 21 F. Supp. 2d at 1102; *Bubble Room*, 36 Fed. Cl. at 674.

In the present case, the petitioner relies upon 26 U.S.C. § 3121(q). The Report of the Senate Committee on Finance on the 1987 amendments to 26 U.S.C. § 3121(q) stated: ". . . employers should be subject to tax on all tips which are *credited for benefits purposes*." S. Print. No. 63, 100th Cong., at 203, 133 Cong. Rec.

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[3] Additionally, it has been suggested that even if the aggregate estimate was correct, current IRS reporting methods for amended tip income statements will not be credited to employees FICA accounts. Brief of Amici Curiae Fior D'Italia, *et al.* on petition for rehearing *en banc* at 1, *Bubble Room, Inc. v. United States*, 159 F.3d 553 (1998).

S34,826 (1987). To allow the collection of FICA taxes without credits to employees' accounts is precisely what the IRS terms a "whipsaw". The IRS is attempting to levy taxes which should be earmarked for redistribution to the employees, without obtaining the necessary information to redistribute these amounts.

II. AGGREGATE ESTIMATES OF UNREPORTED TIP INCOME AT THE EMPLOYEE LEVEL ARE REGULARLY CONDUCTED BY THE IRS AND THE IRS HAS AN ADMINISTRATIVELY VIABLE METHOD FOR ALLOCATING FICA CREDITS

The IRS contends that employee level allocations of FICA credits are not possible due to imprecision. Petitioner's Brief at 9. *See also, Morrison*, 918 F. Supp. at 1514. This contention is particularly surprising, given that the IRS has used estimates to determine the amount of tips received by individual employees since the 1940's. *See Roberts v. Commissioner*, 10 T.C. 581 (1948), *aff'd* 176 F.2d 221 (9th Cir. 1949).

Should the IRS choose to investigate the unreported tip income of an individual employee, the IRS is not without methods. Two procedures exist. The first possibility is that an aggregate assessment will be made of the income from the business and the tip percentage of the employee will be determined. *See e.g., Brown v. Commissioner*, 72 T.C.M. (CCH) 59, (1996); *Bruno v. Commissioner*, 49 T.C.M. (CCH) 1147 (1985); *Meneguzzo v. Commissioner*, 43 T.C. 824, 832 (1965). Alternatively, an hourly tip rate will be determined and multiplied by the number of hours the employee worked.

If the hourly tip rate method is used, the tip rate will be determined by examining the tips received per hour of other employees. *See e.g., Martin v.Commissioner*, 65 T.C.M. (CCH) 2470 (1993); *Louis v. Commissioner*, 63 T.C.M. (CCH) 3098 (1992); *Cohen v. Commissioner*, 60 T.C.M. (CCH) 1509; *Way v. Commissioner*, 60 T.C.M. (CCH) 1264 (1990); *Settle v. Commissioner*, 57 T.C.M. (CCH) 227 (1989); *McGaha v. Commissioner*, 52 T.C.M. (CCH) 517 (1986); *Ward v. Commissioner*, 50 T.C.M. (CCH) 1062 (1985). The IRS has employed both of these methods to determine the individual tax liability for tipped employees. These methods may not accurately estimate the employee's income. If the income is overstated, the employee may not have the funds to pay the taxes due.

The *McQuatters* case is most often cited as the case granting the IRS the authority to make estimates of an individual employee's tip income based upon the combined income of all employees. *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122 (1973). In this case, and in a line of cases since, the IRS's assessments have been successfully challenged as unreasonably high. Although the authority of the IRS to make aggregate assessments under 26 U.S.C. § 446 was upheld in *McQuatters*, the court found that the assessment overestimated the taxpayer's income. *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122 (1973).

The most significant instances of individual tip income audits have been the result of IRS surveillance projects in Nevada and Atlantic City from 1981 through at least 1988. *See Martin,* 65 T.C.M. (CCH) 2470

(Nevada, 1988); *Louis*, 63 T.C.M. (CCH) 3098 (Nevada, 1986-87); *Krause v. Commissioner*, 63 T.C.M. (CCH) 2968 (1992) (Atlantic City, 1980, 1981, 1984, 1985, 1987, 1988, 1990); *Cohen*, 60 T.C.M. (CCH) 1509 (Atlantic City, 1984-1985); *Settle*, 57 T.C.M. (CCH) 227 (Nevada, 1982); *Ward*, 50 T.C.M. (CCH) 1062 (Nevada, 1981-1982). These programs demonstrate that the IRS has at its disposal investigative methods which have been used to allocate tip income among individual employees.

The causes have been varied, but the result is consistent: aggregate assessments ultimately fail to accurately estimate the amount of tip income received by individual employees since employee capabilities and responsibilities vary. For example, under an IRS tip reporting program, it was found that Nevada bartenders' tip rates ranged from 7.9% to 79.4% as a percentage of total sales. Letter from Mark Giarratano, IRS Group Manager to Office of Specialty Taxes (December 11, 1996) *reprinted in* 97 Tax Notes Today 6-27 (1996).

This variability may be the result of efficiency of service, social interaction, time of day, location in the business, and a number of other factors which aggregate assessments do not consider. Successful challenges have been raised for a seemingly endless list of reasons, including: hours worked, type of position, tip-outs to other employees, disabilities, or skill at the position. *See, e.g., Brown*, 72 T.C.M. (CCH) 59 (tip-outs); *Martin*, 65 T.C.M. (CCH) 2470 (tip-outs, pregnancy); *Way*, 60 T.C.M. (CCH) 1264 (coupon sales, credit card stiffing; cash versus credit payments, tip-outs); *Settle*, 57 T.C.M. (CCH) 227 (employee disability); *McGaha*, 52 T.C.M.

(CCH) 517 (different shift times, different positions compared, decreased business due to remodeling and employee desertions); *Ward*, 50 T.C.M. (CCH) 1062 (different positions, changes in popularity of the business); *Bruno*, 49 T.C.M. (CCH) 1147 (tip-outs, amount of alcohol in cocktails, lunchbreaks); *Meneguzzo*, 43 T.C. 824, 834-35 (non-tipped hours, differences in business locations).

In recent employee tip allocation cases, the IRS had made assessments based upon "95% confidence limits". *See e.g., Martin*, 65 T.C.M. (CCH) 2470; *Bruno*, 49 T.C.M. (CCH) 1147. This means that the tip income of 19 out of 20 individuals assessed should be equal to or less than the actual amount of tip income received. *Id.*

Imprecision of the assessments is problematic, but since the IRS believes that these assessments are accurate enough to impose income taxes, these same assessments should be precise enough to allocate FICA credits.

The IRS may be attempting to hide behind the technical distinction between "accuracy" and "precision". While it is possible that the increased accuracy of the estimates (that most individuals are assessed at or below their tip income level) comes at the cost of precision (individuals receiving particularly high tip rates will be significantly underassessed), this method provides an estimate, which by the IRS's own methodology should establish the minimum amount received by the employees in 95% of the cases.

The decision not to credit the FICA accounts of employees whose employers are subject to aggregate assessments is therefore not the result of lack of IRS-endorsed methods. Rather, this is a conscious choice by the IRS to refuse to credit the FICA accounts of employees as a penalty, and not merely an instance of administrative impracticality.

If the IRS's previous representations as to the accuracy of the individual assessments are incorrect, the IRS should discontinue the practice of individual tip income assessments. Indeed, the number of challenges sustained by the courts to the methodology indicates that there may be serious doubt as to the validity of these methods. As long as the IRS employs a method of determining individual employee tip income amounts, it should be equally appropriate to apply that method for allocating FICA credits to the individual employees' accounts.

CONCLUSION

The IRS is imposing FICA taxes without obtaining the necessary information to allow effective administration of the Social Security system. The IRS has justified this failure, in part, by reliance upon a claim that it lacks an appropriate method for allocating employee FICA credits. This is contrary to the IRS position that it is able to accurately assess individual employee tip income for the purpose of collecting income taxes. Taxpayers deserve uniform and fair treatment by the IRS.

If the allocations of individual employee income are indeed inappropriate, the practice should be discontinued. If these allocations are appropriate, then they should be implemented in the context of distributing FICA credits to prevent the collection of FICA taxes from becoming a general revenue raising device.

The imposition of FICA taxes without respect to the earnings record of any employee is contrary to the purpose of the Social Security system and is clearly outside the legislative expectations for the Social Security system.

Accordingly, the judgment of the Ninth Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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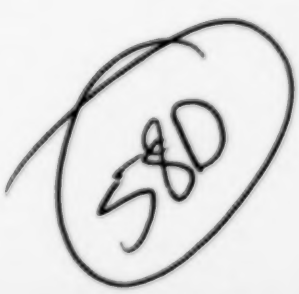

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IN THE

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UNITED STATES OF AMERICA,

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v.

FIOR D'ITALIA, INC.

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF AMICUS CURIAE FOR THE AMERICAN GAMING ASSOCIATION IN SUPPORT OF RESPONDENT

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On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF AMICUS CURIAE FOR THE AMERICAN GAMING ASSOCIATION IN SUPPORT OF RESPONDENT

STATEMENT OF INTEREST OF AMICUS CURIAE

The American Gaming Association ("AGA") is a nonprofit trade association that represents the commercial casino industry in addressing federal legislative and regulatory issues.[1] It also serves as a clearinghouse for information,

[1] Pursuant to this Court's Rule 37.6, we note that no part of this brief was authored by counsel for any party, and no person or entity other than the American Gaming Association or its members made any monetary contribution to the preparation or submission of the brief.

develops educational and advocacy programs, and provides industry leadership in addressing issues of public concern. AGA has 19 casino members who own or operate 151 gaming properties, accounting for approximately three-quarters of the country's commercial gaming revenue. AGA members employ a broad range of workers who receive tips from customers in the course of their employment, including food and beverage workers, casino gaming staff, hotel bell staff, and parking valets.

In this case, the Ninth Circuit ruled that the Internal Revenue Service ("IRS") may not determine an employer's share of Federal Insurance Contribution Act ("FICA") taxes under 26 U.S.C. § 3111 on the basis of an aggregate estimate of the tips received by the employer's tipped workforce as a whole. Rather, the Ninth Circuit held, the IRS must determine the employer's share of FICA taxes on an employee-by-employee basis using the actual tips received by each employee. In light of the number of tipped workers in their employ, AGA members have a direct and substantial interest in this question. AGA members also have substantial historical experience with the evolution of the Federal tax laws governing an employer's FICA tax obligation with respect to tipped employees.

This brief is filed with the written consent of all parties pursuant to this Court's Rule 37.3(a). Copies of the requisite consent letters have been filed with the Clerk.

STATEMENT OF THE CASE

Employers such as hotels, restaurants, and casinos typically employ various workers—including waiters, bell staff, and parking valets—who derive part of their earnings from tips received from customers. Some of these employees, such as table bussers, bartenders, and floor captains, receive tips indirectly from other workers who share their tips with them. All tips earned by employees are "deemed to have been paid by [their] employer[s]," who must pay FICA taxes on those

tips deemed "wages" for FICA tax purposes. 26 U.S.C. §§ 3111, 3121(q).[2]

Employers, however, face both practical and legal obstacles that severely limit their ability to determine the amount of tips earned by their tipped employees. To begin with, an employer has little control over whether and how much an employee may be tipped for a particular service. Tips are generally bestowed at the customer's discretion, in an amount determined by the customer. The employer is not a party to the tip transaction. An employee's tips may vary greatly depending on the time of day, day of week, service area location, level of staffing, occupancy rate of a facility, the employee's personality and efficiency, method of payment (cash or credit card), and the employee's generosity in sharing tips with co-workers. According to a study by the IRS of tipping practices in the food service industry, "[c]ustomers failed to leave tips on close to nine percent of the gross receipts of the establishments." Internal Revenue Serv., U.S. Dep't of the Treasury, *Tip Income Study: A Study of Tipping Practices in the Food Service Industry for 1984*, Pub. No. 1530, at 4 (Aug. 1990).

Industry experience, moreover, is that a high percentage of tips are made in cash. According to the IRS study, "[c]harged tips were left on only 20 percent of the total amount of the establishments' gross receipts, while cash tips were left on over 71 percent of total receipts." *Id.* Indeed, some employees—such as parking valets and bell staff—receive only cash tips. Receipts from cash transactions

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[2] "Wages" for FICA tax purposes include all tips except those received by an employee who earns more than $20 in tips any given month, and those which exceed the Social Security wage base. 26 U.S.C. §§ 3121(a)(1), (a)(12)(B), 3121(q). Those amounts establish what is known as the "wages band." *See* Pet. App. 3a-4a. Only those tips falling within the wages band are subject to FICA taxes.

reflect only the charge for items such as food and beverages, not any gratuity left by the customer for an employee. Because cash tips are paid by customers directly to employees, an employer has no way of knowing the amount of cash tips an employee has received.

Nor can the employer accurately determine what an employee earns in tips from credit card receipts. Although credit card receipts may indicate the amount of a tip received by an employee from a customer, such receipts will not reflect tips passed along by the employee to co-workers such as bus or bar staff. Any effort to use credit card receipts as the basis for reporting employee tips would impose an onerous administrative burden on the employer. Employers in the gaming industry, for instance, would be faced with the difficulty and heavy expense of trying to integrate three different computer systems, in order to transfer data from the point-of-sale system to the time and attendance system, and then to the payroll system.

In addition to such practical difficulties, employers may face legal obstacles to determining the amount of tips earned by employees. State labor laws sharply restrict any potential employer involvement with tips. *See, e.g.*, Cal. Labor Code § 351; Nev. Rev. Stat. § 608.160. In California, for example, an employer may not "collect, take, or receive any gratuity or a part thereof that is paid, given to, or left for an employee by a patron." Cal. Labor Code § 351. The law declares that "[e]very gratuity is * * * to be the sole property of the employee or employees to whom it was paid, given, or left for." *Id.* Similarly, in Nevada, it is unlawful for any person to "[t]ake all or part of any tips or gratuities bestowed upon his employees." Nev. Rev. Stat. § 608.160. Such laws effectively prevent employers from exercising any significant control over an employee's tips. As a result, employers have simply no way of ascertaining the actual tip income of their employees.

The amount of tips earned by an employee is thus uniquely within the employee's knowledge and control. Not surprisingly, when it comes to tip income, the core mechanism of the FICA tax system adopted by Congress reflects this reality by focusing on the reporting of tips by the employee to the employer, upon which the employer may rely. The Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286 (1965), extended Social Security and FICA coverage to tips for the first time. As a committee report on that legislation noted:

> The principal difficulty [in extending social security coverage to tips] has been to devise a fair and practical system for obtaining information on amounts of tips received by an individual which could serve as a basis for contributions and benefit credits. * * * The committee has * * * decided that the only equitable way of counting tips toward benefits is on the basis of actual amounts of tips received and that *the only practical way to get this information is to require employees to report their tips to the employer*. [H.R. Rep. No. 89-213, at 96 (1965) (emphasis added).]

Accordingly, all tipped employees must submit monthly reports to their employers of all tips received that constitute "wages." 26 U.S.C. § 6053(a).[3] Congress placed the onus of compliance with this employee-based reporting system squarely on the employee by subjecting any employee who fails to report all tips to a penalty in an amount equal to 50 percent of the employee's share of FICA tax on such unreported tips (in addition to the employee's share of FICA tax otherwise due). *See id.* at § 6652(b).

Using the tip report provided by the employee, the employer withholds from the employee's wages the employee's

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[3] The tip report may be made on Form 4070 or in another written statement. 26 C.F.R. § 31.6053-1(b)(2).

share of FICA tax on reported tips. *See* 26 U.S.C. § 3102(c)(1). The employer also uses the employee's tip report to determine its own share of FICA taxes. To calculate that share, the employer uses Form 941 ("Employer's Quarterly Federal Tax Return"), which combines the employer and employee FICA tax rates into a single overall rate. That rate is applied to all "taxable social security tips"—defined by the IRS for this purpose as "all tips *your employees reported* during the quarter," up to the Social Security wage base. Internal Revenue Serv., U.S. Dep't of the Treasury, *Instructions for Form 941 – Employer's Quarterly Federal Tax Return*, at 3 (Rev. Jan. 2002) (emphasis added).[4] The employer also reports "such tips as are included in statements furnished [by the employee] to the employer" to the IRS and the employee on Form W-2 as taxable wages of the employee for the year. 26 U.S.C. § 6051(a).

SUMMARY OF ARGUMENT

In this case, the IRS seeks to improperly shift its responsibility for policing employee tip compliance to the employer. As the language and legislative history of congressional enactments regarding FICA taxes over the last several decades make clear, Congress has steadfastly refused to impose this burden on employers.

Tips are uniquely within the knowledge and control of the employee. The employer lacks the ability, independent of reports from employees, to determine, verify, or exercise control over the tips received by an employee. The tip transaction occurs solely between the customer and the individual employee; the employer is not a party to the transaction. Because of the employee's knowledge and control over the tips and the employer's lack of such knowl-

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[4] IRS forms and instructions are contained in IRS Pub. 1132, *Reproducible Copies of Federal Tax Forms and Instructions* (2000).

edge and control, the core mechanism of the FICA tax system adopted by Congress is the reporting of tips by the employee to the employer, upon which the employer may rely.

The focus of Congress in adopting the statutory regime governing tip compliance for FICA tax purposes has been on encouraging the employee to make the proper tip report to the employer and on providing the IRS with the tools to audit the individual employee on his or her income, tip reports, and books and records. This is a responsibility that the IRS now disclaims in the case at hand. Rather, the IRS would require the employer to make an entirely different computation of tips for purposes of the employer's share of the FICA tax—as simply an aggregate estimate for the employer's workforce as a whole based upon an assumed flat percentage of the employer's gross sales. Under the IRS's approach, the individual employees are not reviewed, and no attempt is made to correlate this artificial construct of an aggregate estimate of tips for the employer's workforce as a whole with the actual tip income of any particular employee.

The result of the IRS's FICA tax assessment solely against the employer using an aggregate estimate is to place the burden on the employer to somehow independently quantify the amount of tip payments the employee has received from customers. The IRS seeks to force the employer to prove the negative—that its employees did not receive tips over and above those reported to the employer—in tipping transactions to which the employer was never a party and had no direct knowledge of the particular circumstances. Such IRS efforts to shift the burden of responsibility to the employer for tip determination, auditing, and enforcement have been consistently rejected by Congress.

Accordingly, an IRS assessment of FICA tax on the employer based solely upon an employer-only audit using the artificial construct of an aggregate estimate of tips for the

employer's workforce as a whole based upon an assumed flat percentage of the employer's total gross sales—without regard to the actual tips of any employee—is unauthorized and invalid. Prior to approaching the employer, the IRS first must discharge its responsibility to conduct audits of the individual employees to determine whether an employee has underreported actual tip income.

ARGUMENT

I. NOTHING IN THE INTERNAL REVENUE CODE AUTHORIZES THE IRS TO USE AN AGGREGATE ESTIMATE OF TIPS TO ASSESS AN EMPLOYER'S SHARE OF FICA TAXES.

1. As discussed, the actual amount of tips earned by an employee is uniquely within the employee's knowledge and control, and employers lack the ability to determine how much an employee has earned in tips. Thus, as the Ninth Circuit correctly concluded below, if the IRS believes that members of an employer's workforce have underreported tips, "there is no way to determine [an] employer's tax liability without making an employee-by-employee determination of the taxable tips each has earned." Pet. App. 13a.

In this case, the IRS did not make such individual determinations in assessing the employer's liability. Instead, the agency chose to make an aggregate estimate of tips earned by the employer's workforce as a whole based on an assumed flat percentage of the employer's total gross sales. Nothing in the Internal Revenue Code authorizes the IRS to use such a method to determine an employer's share of FICA taxes.

In the courts below, the Government relied heavily on Section 3121(q) of the Internal Revenue Code as a basis for its purported authority to use an aggregate estimate of tips to assess an employer's FICA liability. *See* Pet. App. 10a-11a, 41a-42a. That section provides that tips received by an employee are "deemed to have been paid by the employer"

for FICA tax purposes. 26 U.S.C. § 3121(q). It further provides:

> Such remuneration shall be deemed to be paid at the time a written statement including such tips is furnished to the employer pursuant to section 6053(a) or (if no statement including such tips is so furnished) at the time received; except that, in determining the employer's liability in connection with [its share of FICA taxes] with respect to such tips in any case where no statement including such tips was so furnished (or to the extent the statement so furnished was inaccurate or incomplete), such remuneration shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer by the Secretary. [*Id.*]

The Government maintains that because Section 3121(q) "provides 'that an employer can be assessed for its share of FICA taxes on employee tips even if the employee fails to report all tips,' " it "thereby 'suggests that the employer can be assessed its share of FICA taxes even when the individual employee's share is not determined.' " Pet. Br. 16 (quoting *Morrison Restaurants, Inc.* v. *United States*, 118 F.3d 1526, 1529 (11th Cir. 1997)).

Nothing in Section 3121(q), however, suggests that an employer may be assessed its share of FICA taxes when the amount of tips actually earned by the individual employee has not been determined. The statute merely provides that where an employee fails to provide a statement of tips to an employer or where the statement provided is inaccurate or incomplete, such tips "shall be deemed for purposes of subtitle F to be paid on the date on which notice and demand for such taxes is made to the employer." 26 U.S.C. § 3121(q). The purpose of this language is to clarify timing issues, not to confer substantive powers upon the IRS. Subtitle F contains the procedural and administrative provisions of the Internal Revenue Code, including those con-

cerning the limitations period for assessments and collection (Section 6501), and the accrual of interest on unpaid taxes (Section 6601). Thus, all Section 3121(q) does is establish limitations and interest accrual periods in cases where an employee has failed to report all tips.

It is of no help to the Government that Section 3121(q) contemplates that an employer may be liable for its portion of FICA taxes even where an employee fails to report all tips. As the Ninth Circuit below observed, "[n]othing in the text of section 3121(q) speaks to the *method* the IRS may use in making its assessment." Pet. App. 11a (emphasis in original). Indeed, the most sensible reading of the statute is that Congress wanted to ensure that the IRS would have the opportunity to assess an employer its share of FICA taxes in the event it audited an employee and discovered unreported tips. If the normal limitations period applied, that opportunity might be lost. As the Ninth Circuit explained, "Section 3121(q) solves this problem by keeping the period open indefinitely—which means for however long it takes to complete [an] audit of the [taxpayer's] tipped employees." Pet. App. 12a.[5]

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[5] The Government seeks support for its interpretation in a statement in the Conference Report to the legislation that enacted the current version of Section 3121(q) to the effect that the employer portion of the FICA tax must be paid " 'on the total amount of wages and cash tips up to the Social Security wage base.' " Pet. Br. 16 (quoting H.R. Conf. Rep. No. 100-495, at 802 (1987)). But that statement no more answers the question whether the IRS may use an aggregate estimate of tips than the statute itself. Rather, the statement merely describes a change in the law rendered by the enactment of the current version of Section 3121(q). Prior to that enactment, an employer's share of FICA taxes on tip income was limited to tips counted towards the federal minimum wage. *See* Pet. Br. 16 n.12. The current version of Section 3121(q) extends the employer's FICA tax obligation to all tips falling within the wages band. The statement in the Conference Report simply makes that clear.

2. The Government now asserts that the "correct[] * * * source of the agency's general authority to use estimates in making FICA tax assessments" is Section 6201 of the Internal Revenue Code. Pet. Br. 23. That section simply authorizes the Secretary of the Treasury to "make the inquiries, determinations, and assessments of all taxes * * * imposed by this title." 26 U.S.C. § 6201(a). It by no means grants the IRS the authority to use any particular method of assessment, much less the method employed by the IRS here. Nevertheless, the Government maintains that Section 6201 " 'implicitly authorizes the IRS to use an indirect formula.' " Pet. Br. 24 (quoting *Bubble Room, Inc.* v. *United States*, 159 F.3d 553, 565 (Fed. Cir. 1998)). But as Judge Plager noted in his dissent in *Bubble Room*, "[t]hat is akin to saying that a statute that authorizes the [IRS] to adopt rules and regulations implicitly authorizes whatever regulations the [IRS] adopts, regardless of their scope or content." 159 F.3d at 571. The Government's contention that there is " 'no other way to 'determine and assess' the wages deemed to have been paid by the employer' " is simply wrong. Pet. Br. 24 (quoting *Bubble Room*, 159 F.3d at 565). As we have explained, there is another, and much better, way to determine an employer's FICA liability—by "making an employee-by-employee determination of the taxable tips each has earned." Pet. App. 13a.[6]

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[6] The Government argues that "[b]ecause an employer is not assessed the employer FICA tax separately for each employee, there is no requirement that the tax be calculated based upon individual employee determinations." Pet. Br. 20. As support for that proposition, the Government notes that "[a]s shown on [Form 941], employer FICA taxes are imposed on the aggregate amount of tips and other wages received by *all* of the employer's employees." *Id.* (emphasis in original). What the Government overlooks, however, is that the IRS's instructions to Form 941 only require the employer to calculate its share of FICA taxes on *reported* tips. *See supra* at 6.

3. The Government also relies on Section 446(b) of the Internal Revenue Code as support for its purported authority to make the assessment at issue here. *See* Pet. Br. 20-23. That section provides that "[i]f no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income." 26 U.S.C. § 446(b). Section 446(b) thus gives the IRS the authority to use estimates to determine the amount of an employee's unreported tips for income tax purposes. *See, e.g., McQuatters* v. *Commissioner*, 32 T.C.M. (CCH) 1122 (1973).

As the Ninth Circuit held below, "the IRS cannot rely on section 446 as authority for the assessment here because the section does not apply to the collection of *FICA* taxes." Pet. App. 10a (emphasis added). By its terms, Section 446(b) applies only to the computation of *income* taxes. The Government recognizes as much, but suggests that Section 446(b) should somehow be "informative." Pet. Br. 22. Employers are in such a different position from their employees with respect to tips, however, that Section 446(b) simply has no relevance here.

Tipped employees, like everyone else, are required to report their income to the IRS and to maintain adequate records of income—including, in their case, tips. *See, e.g., Anson* v. *Commissioner*, 328 F.2d 703, 705 (10th Cir. 1964) ("[T]he privilege of original self-assessment accorded the taxpayer carries with it the burden of support through maintenance of records which clearly and accurately reflect income.") If an employee fails to discharge its reporting and recordkeeping duties, Section 446 specifically authorizes the IRS to undertake a reasonable reconstruction of the employee's income. *See* 26 U.S.C. § 446(b).[7] Because the employee actually

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[7] In *McQuatters*, for instance, the taxpayers were unable to produce records of their actual tip income or demonstrate that they

receives the tip income, the employee is uniquely in a position to challenge an assessment based on an estimate of the tips the employee has earned. *See, e.g., Anson*, 328 F.2d at 705 ("The cumulative amount of gratuities received is peculiarly within the knowledge of the recipient and is not subject to exact verification from records kept by the employer, the contributor, or others.").

The employer, by contrast, is not required to keep records of tip income, except to the extent the employee reports tips to the employer under the employee-based tip reporting system adopted by Congress. Apart from what has been reported by the employee, the employer has no idea how much the employee has earned in tips. *See, e.g.*, Pet. App. 7a ("While each employee knows how much he receives in tips, the restaurant does not."). Thus, unlike an employee who actually receives tips, an employer is not in any position to challenge an estimate of its FICA tax liability. Unlike the IRS, the employer cannot audit its employees to establish the actual amount of their tip income.

As the Ninth Circuit recognized, "[f]orcing [the employer] to prove that [an] estimate is wrong puts an impossible burden on it." Pet. App. 8a. This is especially troubling where, as here, the employer has discharged its reporting and recordkeeping duties and thus done everything required of it by law. *See id.* ("Unlike the taxpayers in *McQuatters* and *Mendelson*, then, the taxpayer in [this] case did not fail to satisfy a legal duty imposed on it by the Internal Revenue Code, and thus did not give the IRS just cause for resorting to

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had done a significant amount of "low tipping" work. *See* 32 T.C.M. (CCH) at 1125. Thus, it was deemed entirely appropriate for the IRS to use an estimate to determine their unreported tip income. *Id. See also Mendelson* v. *Commissioner*, 305 F.2d 519, 523 (7th Cir. 1962) (upholding assessment based on estimate of tip income where taxpayer failed to keep records of such income), *cert. denied*, 371 U.S. 377 (1962).

an estimate in constructing its assessment.").[8] For such reasons, no doubt, Congress has not authorized the IRS to use such estimates in FICA tax cases as it has in income tax cases.[9] If the IRS believes that an employer is liable for additional FICA taxes because employees have underreported tips, the IRS must proceed in the only manner permitted by law—by making individual determinations of actual tip income.[10]

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[8] The cases cited by the Government involving the use of estimates to reconstruct a taxpayer's unreported income are therefore wholly inapposite. *See* Pet. Br. 21-22.

[9] The Government seeks to have it both ways in quibbling over whether Section 446(b) in fact specifically authorizes the IRS to use estimates in income tax cases. *See* Pet. Br. 22-23. In providing that the IRS may compute taxable income "under such method as, in the opinion of the Secretary, does clearly reflect income," 26 U.S.C. § 446(b), Congress plainly gave the IRS "broad authority to use estimates in making income tax assessments." Pet. App. 10a. The absence of a similar provision giving the IRS such authority in FICA tax cases is a strong indication in and of itself that Congress did not intend the IRS to have such authority. *See Barnhart* v. *Sigmon Coal Co.*, 122 S. Ct. 941, 951 (2002) ("[I]t is a general principle of statutory construction that when 'Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion' ") (quoting *Russello* v. *United States*, 464 U.S. 16, 23 (1983)).

[10] Contrary to the Government's assertion, an aggregate estimate of tips earned by the employer's workforce as a whole based on an assumed flat percentage of the employer's gross sales is *not* "far more likely to achieve factual accuracy" than individual determinations of tip income. Pet. Br. 25. As we have explained, because the amount of tips actually earned is peculiarly within the knowledge of employees, they are uniquely positioned to challenge an estimate of the tips they have earned. As a result, individual determinations of tip income are in fact more likely to be accurate, and will not necessarily yield the same result as the

II. CONGRESS HAS STEADFASTLY REFUSED TO ALLOW THE IRS TO SHIFT THE BURDEN OF ENFORCEMENT TO EMPLOYERS.

The result of an assessment based on an aggregate estimate of tips is to put on the employer the burden of independently quantifying the amount of tips an employee has received from customers. Accordingly, the assessment method used in this case effectively shifts from the IRS to employers the agency's responsibility to ensure compliance with the Code's tip reporting requirements.

Such an approach plainly contravenes congressional intent. In a series of enactments over the last 30 years, Congress has consistently blocked efforts by the IRS to shift the burden of tip reporting enforcement to employers—who, after all, are distinctly ill-equipped to police the tip reporting of their employees. Congress's steadfast refusal to allow the IRS to shift its responsibility to employers precludes an interpretation of the Code that authorizes the assessment method used here. *See, e.g., FDA* v. *Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 155-156 (2000) (legislative enactments over the years precluded an interpretation of the Food, Drug, and Cosmetic Act which gave the FDA jurisdiction to regulate tobacco products).[11]

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aggregate estimate method the Government advocates here. Indeed, such individual determinations are the only way to segregate tips falling within the "wages band" from aggregate tips, since those amounts cannot be determined unless an individual employee's tip income is known.

[11] As this Court has held, "the implications of a statute may be altered by the implications of a later statute." *United States* v. *Fausto*, 484 U.S. 439, 453 (1988). All the legislation discussed below was passed after the enactment in 1954 of Section 6201(a), *see* Pub. L. No. 83-591, § 6201, 68A Stat. 3, 767 (1954) ("Internal Revenue Code of 1954"), the general provision which the Government claims "broadly authorizes" the IRS to use an aggregate

In 1976, Congress invalidated a pair of IRS rulings which would have made employers responsible for determining a portion of their employees' tip income. Those rulings required employers to report on Form W-2 all tips included on credit card receipts and paid over in cash to an employee by the employer, regardless of whether the employee reported such tips to the employer. *See* Rev. Rul. 75-400, 1975-2 C.B. 464 (1975); Rev. Rul. 76-231, 1976-1 C.B. 378 (1976). Congress moved quickly to squelch that requirement by retroactively suspending the effect of the IRS's rulings. *See* Pub. L. No. 94-455, § 2111, 90 Stat. 1520, 1905 (1976) ("Tax Reform Act of 1976"); S. Conf. Rep. No. 94-1236, at 498 (1976).

In the Revenue Act of 1978, Congress made that prohibition against employer charge tip reporting permanent by adopting what is now Section 6041(e) of the Code. *See* Pub. L. No. 95-600, § 501(b), 92 Stat. 2763, 2878 (1978); 26 U.S.C. § 6041(e).[12] The Conference Report accompanying the bill containing Section 6041(e) emphasized that "the only employee tips which an employer must report to the IRS are those reported to the employer by employees." H.R. Conf. Rep. No. 95-1800, at 271 (1978). The Senate Committee Report further explained that "an employer will be required to keep charge receipts (which receipts reflect the amount of tips included by the customer in the charged amount), but may not be required to record on such charge receipts, or otherwise keep records of (except copies of [employee] sec.

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assessment method. Pet. Br. 23. *See also Busie* v. *United States*, 446 U.S. 398, 406 (1980) ("a more specific statute will be given precedence over a more general one, regardless of their temporal sequence").

[12] Section 6041(e) exempts tips required to be reported by employees to employers under Section 6053(a) from Section 6041(a) (requiring employers to report to the IRS total earnings paid to an employee), on which the IRS's rulings were based.

6053(a) statements), the name of any particular employee to whom the charge tip amount is paid over by the employer." S. Rep. No. 95-1263, at 213 (1978). As the Senate Committee explained in rejecting the IRS's attempt to impose such requirements upon employers:

> [R]equiring employers to report to the IRS charge account tips paid to employees on the basis of charge receipts (as sought to be imposed by Revenue Rulings 75-400 and 76-231) would place *unnecessary recordkeeping and reporting burdens on the employer* and would fail to provide the IRS with precise information on the amount of tip income taxable to particular employees. [*Id.* at 212 (emphasis added).]

In its most recent comprehensive review of the tip compliance rules for FICA tax purposes, Congress continued its longstanding focus on *employee* compliance by adopting a provision to improve tip reporting by the employee to the employer. In the "Tax Equity and Fiscal Responsibility Act of 1982," Congress enacted a requirement that food and beverage establishments with ten or more employees report certain information to the IRS, including the employer's gross receipts, the aggregate amount of charge receipts, and the aggregate amount of charge tips. *See* Pub. L. No. 97-248, § 314(a), 96 Stat. 324, 603-605 (1982); 26 U.S.C. § 6053(c)(1). Congress also required that, if an employer's tipped employees as a whole have reported tips totaling less than 8 percent of the employee's gross receipts, the employer allocate the shortfall among its tipped employees. *See id.* at § 6053(c)(3). Each employee's allocated tips are reported to the IRS and to the employee. *See id.* at § 6053(c)(1)(E), (2)(C).

As the Conference Report to the legislation makes clear, the purpose of these new recordkeeping and reporting requirements was to provide the IRS with additional information to assist the agency in *its* enforcement efforts:

> [T]he rules of present law relating to reporting of tips to employers by their employees and to the resulting withholding of FICA and income taxes is retained. However, *to assist the Internal Revenue Service in its examinations of returns filed by tipped employees*, the bill provides a new set of information reporting requirements for large food and beverage establishments and, under certain circumstances, a tip allocation requirement. [S. Conf. Rep. No. 97-530, at 556-557 (1982) (emphasis added).]

The Conference Report also makes clear that Congress believed that the new requirements would ensure more accurate tip reporting by employees:

> The 8-percent figure reflects the conferees' judgment that the tip rate in establishments subject to this reporting requirement will rarely be below the 8-percent level. Thus, *an employee who reports less than his allocated amount of tips must be able to substantiate his reporting position with adequate books and records (as he must under present law). * * * Employees would be put on notice that their returns would be identified for audit unless this 8 percent tip reporting is satisfied.* [*Id.* at 557-558 (emphasis added).]

Congress specifically refrained from requiring employers to make any determination of tip income based on the information they are required to report. *See id.* at 557 ("The allocation of this 8-percent amount to employees for reporting purposes will have no effect on the FICA or income tax withholding responsibilities of the employer * * *. Thus, employers will continue to withhold only on amounts reported to them by their tipped employees."). As the Senate Committee report makes clear, that responsibility was to remain with the IRS:

> Expanded information reporting on tip income will encourage better reporting of such income by its recipients and facilitate Internal Revenue Service efforts to increase

> compliance in this area. At the same time, the committee recognizes that improved compliance rules should not impose unnecessary recordkeeping obligations on taxpayers or employers. [S. Rep. No. 97-494, at 251-252 (1982).]

In recent legislation, Congress demonstrated once again its refusal to impose the burden of enforcement on the employer. Responding to industry complaints of IRS heavy-handedness, Congress took the extraordinary step of enacting a law directing "[t]he Secretary of the Treasury [to] instruct employees of the Internal Revenue Service that they may not threaten to audit any taxpayer in an attempt to coerce the taxpayer into entering into a Tip Reporting Alternative Commitment [("TRAC")] Agreement." *See* Pub. L. No. 105-206, § 3414, 112 Stat. 685, 755 (1988) ("Internal Revenue Service Restructuring and Reform Act of 1998."). Under a TRAC agreement, an employer agrees to establish new tip reporting procedures, educate its employees about their tip reporting responsibilities, and fulfill various other requirements. In return, the IRS agrees to base the employer's FICA tax liability solely on reported tips and unreported tips discovered in individual audits of employees. *See* Pet. Br. 30.[13] Congress thus made clear that employers cannot be made to undertake the burden of ensuring tip reporting compliance among their employees.[14]

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[13] The IRS has declined to permit the casino industry to participate in the TRAC program.

[14] The Government contends that this enactment "reflects the understanding of Congress that, in the absence of a TRAC agreement, the IRS has full authority to make aggregate assessments against employers without making determinations with respect to individual employees." Pet. Br. 30. That inference does not hold up against Congress's repeated refusal to allow the IRS to shift its enforcement responsibilities to employers.

These actions by Congress clearly manifest a policy against saddling employers with the responsibility of ensuring accurate tip reporting by their employees. Indeed, as in *Brown & Williamson*, *supra*, "this is not a case of simple inaction by Congress that purportedly represents its acquiescence in [a particular] position," 529 U.S. at 155, but one in which Congress has affirmatively and unequivocally expressed its intent. Against this backdrop, an inference that the Code implicitly authorizes the IRS to use an assessment method that shifts the burden of enforcement to employers is untenable.

As one court rejecting the use of an aggregate estimate has put it, "The United States would have [the employer] be its watchdog [but] that it is not contemplated [by the Code]. * * * If the United States is concerned with dishonest taxpayers it has the means to investigate them; but the investigative burden should not be shifted to the withholding employer in the absence of Congressional intent to do so." *Norfolk Yacht & Country Club* v. *United States*, 1975 WL 731, at *7 (E.D. Va. 1975).

* * *

In sum, Congress has made quite clear over the last several decades that the IRS may not shift to employers its responsibility to ensure tip reporting compliance. The entire focus of Congress in adopting the statutory regime governing tip compliance has been on encouraging the employee to make the proper tip report to the employer and on providing the IRS with the tools to audit the individual employee on his or her income, tip reports, and books and records—a responsibility the IRS now disclaims in the case at hand. An assessment by the IRS of FICA tax on the employer based solely upon an employer-only audit using the artificial construct of an aggregate estimate of tips for the employer's workforce as a whole—without regard to the actual tips of any employee—is unauthorized and invalid. Prior to approaching

the employer, the IRS first must discharge its responsibility to conduct audits of the individual employees to determine whether an employee has underreported actual tip income.

CONCLUSION

For the foregoing reasons, the judgment below should be affirmed.

Respectfully submitted,

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No. 01-463

IN THE

Supreme Court of the United States

UNITED STATES OF AMERICA,
Petitioner,

v.

FIOR D'ITALIA,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF *AMICUS CURIAE* OF THE NATIONAL RESTAURANT ASSOCIATION IN SUPPORT OF RESPONDENT

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QUESTION PRESENTED

Petitioner states that the question for review is whether the employer's share of the Federal Insurance Contribution Act (FICA) tax on employee tip income must be determined by accumulating the result of individual audits of individual employees or may instead be based on a reasonable estimate of the aggregate amount of tips received by all employees.

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IN THE

Supreme Court of the United States

No. 01-463

UNITED STATES OF AMERICA,
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Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF *AMICUS CURIAE* OF THE NATIONAL RESTAURANT ASSOCIATION IN SUPPORT OF RESPONDENT

STATEMENT OF INTEREST OF *AMICUS CURIAE*

The National Restaurant Association ("NRA") is the largest trade association representing restaurants in the United States.[1] Membership in the NRA includes some 52,000 foodservice establishments, with over 254,000 restaurant units. The restaurant industry employs an estimated 11.6 million workers, making it the largest private-sector employer

[1] Both Petitioner and Respondent have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus curiae* made a monetary contribution to the preparation or submission of this brief.

in the United States. *2002 National Restaurant Association Restaurant Industry Pocket Factbook* (hereafter "*2002 Restaurant Industry Factbook*").

Government statistical data and/or National Restaurant Association research surveys indicate the following facts about the restaurant industry that may assist the Court with respect to issues being examined in this case:

- There are over 2.4 million directly tipped employees in the restaurant industry (waitstaff and bartenders) and over a half million indirectly tipped employees (buspersons, hosts/hostesses, chefs or cooks, dishwashers, etc.). *U.S. Department of Labor, Bureau of Statistics* (2000).
- Tipped employees at over 14% of all fullservice (tableservice) restaurants participate in tip pools, whereby directly tipped employees share their tips with indirectly tipped employees. *National Restaurant Association Legislative Issues Survey* (1999) (hereafter "*NRA Legislative Survey*").
- 89% of all fullservice (tableservice) restaurants are independently owned and operated, while 11% are owned and operated by chain restaurants. *1997 Economic Census*, U.S. Bureau of the Census.
- 99% of all fullservice (tableservice) restaurants are small businesses as defined by the U.S. Small Business Administration, i.e. foodservice and drinking establishments with annual sales under $5 million. *1997 Economic Census*, U.S. Bureau of the Census.
- 98% of all foodservice and drinking establishments have fewer than 100 employees. *1997 Economic Census*, U.S. Bureau of the Census.

- 58% of all fullservice restaurants have under $500,000 gross annual income; 21% have gross annual income between half and one million dollars; and 20% are between $1.0 – 4.9 million. *1997 Economic Census*, U.S. Bureau of the Census.
- 10% of all fullservice (tableservice) restaurants have been audited by the IRS based on the amount of tips reported. *NRA Legislative Survey.*
- 12% of restaurants file their tax returns under the "Alternative Minimum Tax" (AMT) provision of the Internal Revenue Code (IRC). *NRA Legislative Survey.*
- Fullservice (tableservice) restaurants operate on average at a 4 to 5% profit margin each year. *2001 [National Restaurant Association] Restaurant Industry Operations Report.*

SUMMARY OF ARGUMENT

The Government's interpretation that the Federal Insurance Contribution Act (FICA) permits the IRS to assess a FICA tax on restaurant employers based on an estimate of the aggregate amount of tips the IRS believes were received by all of the restaurant's employees is neither authorized by Congress nor a rational approach as applied to the restaurant industry.

ARGUMENT

I. NEITHER THE STATUTE NOR THE LEGISLATIVE HISTORY AUTHORIZES AN EMPLOYER FICA TAX ASSESSMENT BASED ON AN AGGREGATE ESTIMATE OF UNREPORTED TIPS.

The Government argues that Congress permitted the IRS to impose on restaurant employers a FICA tax on tips the IRS

estimates were not reported by all employees as a group rather than determining on an individual basis who underreported tips and the amount. *Amicus curiae*, the National Restaurant Association ("NRA"), believes that this approach is not statutorily authorized and disregards the clear intent of Congress.

Congress stated in 26 U.S.C. 3101(a) that there is imposed "on the income of every *individual*" a tax equal to certain specified wage percentages. (Emphasis added). In 26 U.S.C. 3121(a) Congress excluded from the definition of "wages" for the FICA tax imposed by sections 3101(a) and 3111(a) remuneration (tips) "paid to *an individual*" in excess of the contribution and benefit base (the annual wage limitation). Congress provided in 26 U.S.C. 3121(q) that "tips received by *an employee* in the course of his [or her] employment shall be considered remuneration for such employment." (Emphasis added).

These statutory sections clearly indicate that Congress intended that an *individual-by-individual determination* must be made as to tip income, including the tips *each employee* failed to report before it is appropriate to make a FICA tax assessment. There is no indication, explicit or implicit, that Congress allowed the IRS to *disregard the individual determination approach* and permit determinations to be made on the basis of an aggregate estimate for all employees. Statutory provisions that are clear and unambiguous on their face should not be disregarded by the agency directed to enforce the Congressional mandate. *See, e.g., Jay v. Boyd*, 351 U.S. 345 (1956).

While *Amicus* believes that this should end the matter and result in dismissal of the Government's petition, *cf., Chevron U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 842 (1984), the legislative history of IRC 3121(q), while sparse, further reflects Congressional intent that an *individual-by-individual determination* is required. Congress predicated the

statutory amendments imposing a FICA tax on all tips in 1987 on the basis that such tips be credited to *each employee's* social security account. The Senate Committee Report to the 1987 enactments, S. Print No. 63, at 203 (1987), 133 Cong. Rec. 534, 826 (1987), states in relevant part:

> in order to apportion the costs of social security benefits more accurately, employers should be subject to [FICA] tax on all tips *which are credited for benefit purposes*. (Emphasis added).

The Government's aggregate tip estimate approach and resulting assessment based on the estimate does *not* credit the social security wage earnings history of any employee. Such arbitrary and capricious interpretations of statutory provisions that disregard the clear directive of Congress should be given no deference. *Cf.*, *United States v. Mead Corp.*, 533 U.S. 218 (2001); *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

II. THE GOVERNMENT'S ASSERTION THAT RESTAURANT EMPLOYERS MUST DISPROVE THE IRS' FICA TAX ASSESSMENT PLACES THE BURDEN ON THE WRONG PARTY AND MISUNDERSTANDS THE TIPPING PROCESS IN THE RESTAURANT INDUSTRY.

The Government argues in its brief at 7 and 12 that Respondent, Fior d'Italia, "must prove that the [IRS'] assessment is erroneous and [that Fior d'Italia] must then establish the correct amount of the tax owed." Such an approach is illogical, makes it impossible for restaurant employers to meet the burden, and virtually assures that the IRS' assessment will be conclusive in every circumstance.

The IRS' FICA tax assessment against Respondent is based on its estimate about tips that employees allegedly failed to report. However, for Fior d'Italia (or any restaurant

employer) to rebut the IRS' estimate necessitates in the first instance that Respondent (or any other restaurant employer) possess information about the unreported tips. That, however, is not the case.

As the Government admits in its brief at 2, the law requires that tipped employees report to the employer the tips they receive on a monthly basis. 26 U.S.C. 6053 (a). In turn, restaurant employers with essentially 10 or more employees must make annual reports of tips reported to them by their employees. 26 U.S.C. 6053 (c) (1) (4). However, beyond these two statutory mandates, the law requires no further involvement by the employer in the employee's tip reporting process. Congress did *not* place the burden of finding out what tips were underreported by employees on the restaurant employer. That is the IRS' job.

Furthermore, the Government's requirement that the employer disprove the IRS assessment based on its aggregate unreported tip estimate evidences a substantial misunderstanding about the tipping process in the restaurant industry. Tips are deemed to be a gratuity from the customer to the employee. The restaurant employer neither directs a customer to leave a tip nor does it determine the amount. By law, tips are considered to be the property of the employee, not the property of the employer, and are included in the gross income of the employee. 26 C.F.R. 1.451-1(c). They are *not* computed as part of a restaurant's corporate income. Indeed, under the Fair Labor Standards Act of 1938, 29 U.S.C. 201 *et seq.* (FLSA), only tips received and reported by employees that are "free of any control by the employer" may be used to meet the employer's minimum wage obligations. 29 C.F.R. 531.52. Employers are clearly not involved in the tip transaction process between the customer and the server.

Indeed, restaurant employers have no knowledge about the amount of tips each employee receives other than what each employee reports. For example, as to cash receipts, the

directly tipped employee collects the cash from the customer and then returns to the employer only an amount to cover the food and drink (and any applicable sales tax) portion of the payment. The tip amount remains in the control of the employee, and unless the tips are reported to the employer, the amount is known only by the directly tipped employee. As to credit card tips, while the employer possesses credit card receipts that show the tip amount, unless the employer institutes a tracking system to identify each server with each credit card receipt (which is not legally required and potentially could be an expensive item for restaurant employers, most of whom operate on a close profit-loss margin of 4 to 5%, *2001 [National Restaurant Association] Restaurant Industry Operations Report*), the employer does not know who received each credit card tip.

It is also important to point out that credit card receipts do not form a sufficient basis to estimate unreported cash tips. Beyond the fact, as pointed out in the majority opinion in the Court of Appeals below and recognized in the industry generally, that cash tips are usually *less* than tips left by customers on credit cards, no basis exists to guess *how much lower* cash tips normally are in comparison to credit card tips. The National Restaurant Association is not aware of any industry study that compiles such information and there is no standard industry understanding.

Finally, it is important to understand that directly tipped employees many times voluntarily share their tips with other employees. For example, employees at some 14% of all fullservice restaurants participate in tip pools. *National Restaurant Association Legislative Issues Survey*, (1999). While some tip pools are overseen by employers under strict guidelines issued by the U.S. Department of Labor under the FLSA, *U.S. Department of Labor, Wage and Hour Division Field Operations Handbook*, Vol. II at 30d04 (1988), other tip pooling arrangements are set up voluntarily by employees

and are controlled by them *outside of any involvement or knowledge* of employers. In addition, directly tipped employees many times will share or "tip out" some of their tips with other employees. Restaurant employers, however, are not involved in these arrangements and normally have little, if any, knowledge about their existence. Indeed, according to government studies, *Tip Income Study: A Study of Tipping Practices in the Foodservice Industry*, Department of Treasury, IRS, Research Div., Pub. 1530 (8-90), Catalogue No. 12482K, only about 80% of tips are retained by restaurant servers since they share or "tip-out" in excess of 20% to other employees.

It is therefore clear in the restaurant industry that restaurant employers have insufficient information about unreported tips in order to challenge or *disprove* the IRS assessment or to establish the correct amount of unreported tips received by their employees. The Government justifies imposing such an onerous burden on restaurant employers by referencing various cases discussing burden of proof about unreported income, *e.g.*, *McQuatters v. Commissioner*, 32 T.C.M. (CCH) 1122 (1973). However, these cases are not applicable to the issue before this Court since they essentially involve *two parties*: (1) the IRS and (2) the taxpayer who has the information about his or her income and yet fails to report the appropriate amount. FICA tax assessments against restaurant employers based on alleged tip income stemming from unreported tips involve a *three-party* system: (1) the IRS; (2) the tipped employee; and (3) the restaurant employer. It is the second party, the *tipped employee*, who is the party possessing the information about his or her tip income, is legally required to keep the information, 26 U.S.C. 6001, and who supposedly has failed to report it. The restaurant *employer only* has information about tips *reported* by the employee. It has no information about an employee's unreported tips, and should not bear the burden of disproving

an IRS assessment when it neither knows nor has access to the tip information upon which the assessment is based.

Consequently, to require restaurant employers, such as Fior d'Italia, to disprove the IRS' speculation about what tips were not reported unfairly places the burden on the wrong party, and virtually assures that the assessment will be conclusive in every circumstance. Such folly circumvents the wisdom of Congress that determinations about tip income be made on an *individual* basis, has no basis in law, and should be rejected. Only *after* the IRS has made an individual employee determination who failed to report what tips and the amount is an assessment for the employer's matching FICA tax appropriate.

CONCLUSION

For the foregoing reasons, the National Restaurant Association respectfully requests that the Government's request for a Writ of Certiorari be denied.

Respectfully submitted,

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